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DESTRUCTIVE COLLECTIVISM: DODD-FRANK COORDINATION AND CLEARINGHOUSES

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The recent financial crises have generated strenuous academic debates on the fundamental premises of market regulation. The interaction between the state and the market is at the core of this discourse. A plethora of postcrisis reforms threaten to undermine the historical monopoly of centralized regulators through more coordinated, "collectivist" approaches to capital market regulation. The dangers of this new collectivism are not fully explored in the current scholarship.

This Article questions the Dodd-Frank coordination mechanisms by demonstrating that crucial benefits may result from the predictability of a linear market-regulator interaction in a cooperative environment. An example of such a successful multiparty interaction is the traditional sector-specific regulatory regime in the clearing and settlement industry.

In clearing, the linear interaction between centralized regulators, such as the SEC, and clearinghouses was associated with market efficiencies, lower regulatory costs, and transaction cost reduction. The relationship was premised on several fundamental postulates, including principles-based regulations, a low frequency of enforcement actions, participatory corporate governance mechanisms that strengthened market self-regulation, a contestable monopoly organization of the industry, and the continuous judicial support of clearing and settlement utilities. To examine these postulates, this Article reviews the history of clearing regulations and forty years of pertinent case law and enforcement actions.

This Article suggests that Dodd-Frank has put forth a questionable approach to reforming—at the very least—successful industries, such as clearing, which were not

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directly implicated in the crisis. In clearing, Dodd-Frank coordination mechanisms should be invoked rarely, and only in cases where specific inefficiencies in the traditional sector-specific model explicitly undermine its benefits, including regulatory flexibility and cooperation between expert regulators and regulated industries.

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INTRODUCTION

Oh, no! Not another paper on the postcrisis swelling of an increasingly inefficient regulatory apparatus! Unfortunately, the topic has not been entirely exhausted yet as new regulations are still in the works and the consequences of the recently finalized ones will call for continuous research for years to come. Moreover, to the extent that the postcrisis reforms instill a new fundamental element into the regulatory fabric—cross-agency coordination that may erode the traditional interaction between individual agencies and the regulated markets—these issues must be addressed.

The post-2008 regulatory coordination evolved in response to the financial crisis[1] and the crisis-driven ad hoc actions of the regulators, which have led to statutory changes and now inhere in the ensuing rules.[2] The fundamental premise of the new rules is the presumptive

1 *See, e.g.*, Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 43–47, 59, 74–90 (2009) (discussing the crisis-driven centralization approach and the Obama Administration's proposal to coordinate supervision).

2 Indeed, most securities-related reforms in the United States are promulgated in the wake of some crisis or market crash. This maxim is also true in the case of Dodd-Frank. As Professor Romano has put it in her recent papers, there is the "Iron Law" of financial regulation, a system that is based on the "enactment [of] invariably crisis driven" regulation. Its repercussion is "a regulatory state whose cumulative regulatory impact produces over time an increasingly ineffective regulatory apparatus." Roberta Romano, *Further Assessment of the Iron Law of Financial Regulation: A Postscript to Regulating in the Dark* 1 (European Corp. Governance

failure of individual functional regulators to grasp and evaluate the complexity of the modern financial markets.[3] In this sense, coordination was viewed as the sine qua non of modern financial regulation.

Postcrisis policymaking has been equally informed by longstanding policy debates about not only improving interagency coordination, but also consolidating all or some regulators.[4] In the end, however, statutes like Dodd-Frank stopped short of establishing a fully consolidated structure.[5] Instead, Dodd-Frank promotes group decision making and increases the authority of the Federal Reserve, thus creating an *underconsolidated* but *overcoordinated* interagency structure.[6]

In the now underconsolidated regulatory system, sector-specific, functional regulators remain the primary supervisory agencies of certain entities and industries. At the same time, their decisions and policies

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Inst., Working Paper No. 273, 2014) [hereinafter Romano, *Iron Law of Financial Regulation*], http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2517853; *see also* Cunningham & Zaring, *supra* note 1, at 50–56 (discussing examples of crises and responses); Larry E. Ribstein, Commentary, *Bubble Laws*, 40 HOUS. L. REV. 77, 79–83 (2003).

3 *See, e.g.*, DEP'T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 4, 27 (2008) [hereinafter DEP'T OF THE TREASURY, BLUEPRINT], http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf (criticizing the functional approach to regulation and the lack of coordination in addressing market stability concerns); GRP. OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 24–32 (2009), http://www.group30.org/images/uploads/publications/G30_FinancialReformFrameworkFinStability.pdf (providing a set of recommendations for banking and nonbank institutions); GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE 49–51 (2008) [hereinafter GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION], http://www.group30.org/images/uploads/publications/G30_StructureFinancialSupervision2008.pdf ("The Integrated Model and the Twin Peaks Model may more rationally reflect the changes that have taken place in the financial services business over the past several years, and thus are widely viewed as more efficient and cost-effective [than the Institutional Approach and the Functional Approach] by both regulators and regulated entities.").

4 *See generally* Howell E. Jackson, *Learning from Eddy: A Meditation upon Organizational Reform of Financial Supervision in Europe*, *in* PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION 523 (Michel Tison et al. eds., 2009); Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. ON REG. 91 (2012); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707 (2009); Cunningham & Zaring, *supra* note 1; Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785 (2009); Robert Hockett, *The Macroprudential Turn: From Institutional 'Safety and Soundness' to Systematic 'Financial Stability' in Financial Supervision*, 9 VA. L. & BUS. REV. 201 (2015); Michael P. Malloy, *Banking in the Twenty-First Century*, 25 J. CORP. L. 787 (2000); Joel Seligman, *The SEC in a Time of Discontinuity*, 95 VA. L. REV. 667, 667–74 (2009); Howell E. Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States* (Harvard Law Sch. Pub. Law & Legal Theory, Working Paper No. 09-19, 2009), http://ssrn.com/abstract=1300431; discussion *infra* Part II.

5 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 111–123, 801–814, 124 Stat. 1376, 1393–1412, 1802–22 (2010) (codified as amended in scattered sections of 7 U.S.C., 12 U.S.C., 15 U.S.C.).

6 *Id.*

may be altered by other public players or *groups* of peer regulators.[7] Generally, this may happen whenever a serious disagreement arises between the primary supervisory agency and other regulatory "parties in interest." In fact, we are currently faced with a decision-making process involving several regulators with different, potentially mismatched, political and regulatory influences and expertise.

The principal example is the authority of the Financial Stability Oversight Council (FSOC) and the Federal Reserve (the Fed) vis-à-vis the jurisdiction of such sector-specific regulators as the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).[8] The Fed or the FSOC, by definition a collegial edifice, in certain circumstances may influence and overrule the decisions of such expert regulators.[9]

Another example is the European Union (EU), where the most extreme species of coordination have been thriving for some time. In the EU, various domestic entities are now operating on very uncertain jurisdictional turf. A number of large financial institutions are overseen by a concoction of national regulators, "colleges" of regulators, various stakeholders, and, at the top of the hierarchy, the EU authorities, including the European Securities and Markets Authority (ESMA) or the European Central Bank.[10]

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7 To be sure, collaborative interagency projects existed in the past and, at times, the Federal Reserve (the Fed) and the Treasury even resorted to "jawboning" strategies. *See, e.g.*, Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 641–45 (2010) (discussing the Fed's intervention and collaboration among agencies). However, Dodd-Frank has further formalized these processes. *See, e.g.*, 12 U.S.C. §§ 5321–5331, 5472 (2012). Another interesting outcome of the reforms was examined by Stavros Gadinis, who documented a global paradigmatic shift toward the involvement of politicians in the formerly independent agencies' decision making. Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327 (2013).

8 For instance, Dodd-Frank strengthens the Fed's participation in the oversight of some of the largest financial institutions and mandates relevant interagency coordination. *See, e.g.*, Saule T. Omarova, *One Step Forward, Two Steps Back? The Institutional Structure of US Financial Services Regulation After the Crisis of 2008*, *in* INSTITUTIONAL STRUCTURE OF FINANCIAL REGULATION: THEORIES AND INTERNATIONAL EXPERIENCES 137, 151–57 (Robin Hui Huang & Dirk Schoenmaker eds., 2015); BD. OF GOVERNORS OF THE FED. RESERVE SYS., SEC. & EXCH. COMM'N & COMMODITY FUTURES TRADING COMM'N, RISK MANAGEMENT SUPERVISION OF DESIGNATED CLEARING ENTITIES 9 (2011) [hereinafter RISK MANAGEMENT SUPERVISION OF DESIGNATED CLEARING ENTITIES], http://www.sec.gov/news/studies/2011/813study.pdf.

9 *See, e.g.*, 12 U.S.C. §§ 5462(1), 5462(8), 5463(a), 5463(c), 5464 (2012).

10 For instance, in clearing and settlement, the EU promotes general principle harmonization accompanied by a mixture of EU-level and national authorities afforded with supervisory and investigatory powers. Council Regulation 909/2014, 2014 O.J. (L 257) 6, 13–14, 33–35 (EU) (indicating these concepts in recitals 24, 68, 70, and 71, and in Article 24); Council Regulation 648/2012, 2012 O.J. (L 201) 8–9, 28 (EU) (in particular recitals 52 and 53, and Article 22); EUROPEAN SEC. & MKTS. AUTH., QUESTIONS AND ANSWERS: IMPLEMENTATION OF THE REGULATION (EU) NO 648/2012 ON OTC DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES (EMIR) (2013), https://www.esma.europa.eu/sites/default/files/library/2015/11/2015_775_qa_xii_on_emir_implementation_april_2015.pdf. The actual regulatory

These new approaches will necessarily implicate the vast scholarship on group dynamics, "the influential actions, processes, and changes that occur within and between groups,"[11] as stronger regulators or interagency coalitions influence weaker regulators. The new regulatory *underconsolidation* approach, which effectively goes beyond basic *interagency coordination*, and the mismatch between the actual power and expertise of the regulators within the groups may result in a number of disturbing outcomes. Cumulatively, this Article refers to those possible decision-making corollaries of the postcrisis coordination reforms as *collectivism*.

This Article discuses various aspects of collectivism in detail in Part II. In a nutshell, as a distinct regulatory risk, *collectivism* is predicated on group decision making, and simultaneously implicates regulatory coordination and accompanying rule harmonization, concepts thoroughly dissected by scholars and policy groups.[12] For instance, the

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structure is thus exceptionally complex. *See, e.g.*, *Our Structure*, EUROCLEAR, https://www.euroclear.com/en/about/our-structure.html (last visited Apr. 8, 2016); *Who Regulates LCH.Clearnet?*, LCH.CLEARNET, http://www.lchclearnet.com/about-us/company-structure (last visited Feb. 9, 2016); *see also* RUBEN LEE, OXFORD FIN. GRP., THE GOVERNANCE OF FINANCIAL MARKET INFRASTRUCTURE 300–09, 339–41 (2010), http://www.oxfordfinancegroup.com/media/10347/gfmi%20ofg.pdf; *see also* Yesha Yadav & Dermot Turing, *The Extra-Territorial Regulation of Clearinghouses* 22–28 (Vanderbilt Univ. Law Sch. Law & Econ., Working Paper No. 15-24, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2659336.

11 DONELSON R. FORSYTH, GROUP DYNAMICS 1 (6th ed. 2014).

12 *See, e.g.*, GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION, *supra* note 3, at 49–51 (emphasizing the need for regulatory coordination and "for a consolidated view of each supervised institution"); COMM. ON PAYMENT & SETTLEMENT SYS. & TECH. COMM. OF THE INT'L ORG. OF SEC. COMM'NS, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES 133 (2012) [hereinafter CPSS-IOSCO, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES], http://www.bis.org/cpmi/publ/d101a.pdf ("Relevant authorities should cooperate with each other, both domestically and internationally, to foster efficient and effective communication and consultation in order to support each other in fulfilling their respective mandates with respect to FMIs."); Cannes Summit Final Declaration, Grp. of Twenty, Building Our Common Future: Renewed Collective Action for the Benefit of All, at paras. 24, 27 (Nov. 4, 2011), http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html; Leaders' Statement, The Pittsburgh Summit: September 24–25 2009, at 3, https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

It is debatable whether regulatory coordination and harmonization are always appropriate and fundamentally positive. *See, e.g.*, James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old SEC*, 95 VA. L. REV. 941, 978–85 (2009) (discussing the nature of the SEC's responses to global trends and generally advocating a slower approach to some harmonization reforms such as accounting standards); Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291 (2014) (discussing alternative approaches, regulatory competition, and diversity arguments); Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 YALE J. ON REG. 1 (2014) (emphasizing key downsides of harmonization); Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 327, 329–30, 346–47 (2011) (discussing the benefits and dangers of coordination, observing that coordination may "become a systemic risk," and emphasizing with respect to the mandate of "the Oversight Council to assess the systemic negative *collectivist* repercussions may manifest themselves through the unnecessarily amplified regulatory apparatus and through exacerbated regulatory procrastination. Likewise, the new interagency decision-making structure may compel the formerly more independent sector-specific agencies to avoid potential confrontation with the Fed and the Treasury—the strong members of the group.[13] This may occur even if the "peers" of the sector-specific regulators do not have the same expertise in regulating an industry in question or equal political independence, viz., the congenital traits of independent agencies.[14] In short, the obvious examples of the risk of collectivism are interagency friction and jawboning maneuvers of the stronger agencies.

The other natural outcomes are regressing toward the "regulatory mean," even when more individual approaches to *specific* industries generate better outcomes, and, ultimately, inefficient regulations. An important aspect of this potential problem is limiting productive cooperation and information exchange between the market and the weakened expert regulators. In drafting regulations, the weaker regulators may pay less attention to the *specific* market's needs and the

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consequences (and costs) of financial regulation and market standards that promote coordination" that "[a] key question is whether, in line with the Act, regulators will balance coordination's benefits against its costs in developing new systemic risk regulation"); *see also* COMM. ON THE GLOB. FIN. SYS., BANK FOR INT'L SETTLEMENTS, CGFS PAPERS NO 41: LONG-TERM ISSUES IN INTERNATIONAL BANKING 31 (2010), http://www.bis.org/publ/cgfs41.pdf (cautioning that in banking, although "regulation has an important role to play in fostering cross-border knowledge transfer[, t]he end result . . . should not be the convergence to a single risk assessment or risk management framework, which would encourage herd behaviour and weaken financial stability. Since any given framework is inevitably imperfect, diversity of approaches would carry large benefits").

Sometimes, however, national regulators must either respond to coordination and harmonization or risk putting domestic entities at a disadvantage. *See, e.g.*, Letter from Larry E. Thompson, Managing Dir. & Gen. Counsel, Depository Tr. & Clearing Corp., to Kevin M. O'Neill, Deputy Sec'y, Sec. & Exch. Comm'n 1–2 (May 27, 2014), https://www.sec.gov/comments/s7-03-14/s70314-16.pdf (providing comments on the proposed rules on covered clearinghouses).

13 There is at least a possibility of such prospective compliance in salient political matters. *See, e.g.*, Bressman & Thompson, *supra* note 7, at 645–46 ("To date, the Secretary of the Treasury has not intervened in SEC decisions often enough to establish a pattern. . . . Even a one-time occurrence demonstrates a possibility that in theory may have seemed incompatible with agency independence.").

14 Indeed, expertise sets independent sector-specific agencies apart from more generalist entities or the executive branch. *See, e.g.*, *id.* at 612–15; Fisch, *supra* note 4, at 823 ("Despite the SEC's recent shortcomings, its history as Wall Street's most effective enforcer, coupled with its expertise at designing and enforcing disclosure requirements, make it the most plausible candidate for the job."); Jonathan S. Masur & Jonathan Remy Nash, *The Institutional Dynamics of Transition Relief*, 85 N.Y.U. L. REV. 391, 448–49 (2010) (discussing the pertinent pros and cons); Seligman, *supra* note 4, at 674–79 (discussing the importance of agency expertise); *see also* Fabrizio Gilardi, *The Institutional Foundations of Regulatory Capitalism: The Diffusion of Independent Regulatory Agencies in Western Europe*, ANNALS AM. ACAD. POL. & SOC. SCI., Mar. 2005, at 84, 84–85 (discussing, generally, political uncertainty issues and the related justifications for the establishment of independent agencies).

information input from those *specific* industries, and instead, promulgate *average* rules and regulations.

Self-evidently, when a regulatory reform creates additional risks, including the risk of collectivism, the reform must be justified by offsetting economic and regulatory benefits. A regulation triggered by a financial crisis and concomitant regulatory failures seems like a straightforward example—a policymaker may rationally expect that the costs of similar regulatory and economic failures in the future, ex hypothesi, are likely to exceed the price tag and risks associated with the new regulations. However, if the regulations overturn a previously successful and efficient market-regulator arrangement (i.e., when a regulated industry and its supervising agency have *not* failed), it should be much harder to make a case for the new rules. Changing the regulatory status quo in that case does not intuitively generate conclusive net benefits.

This Article examines such a scenario. To demonstrate the collectivist risks and potential redundancy of Dodd-Frank overcoordination, the Article juxtaposes it with an effective approach applied in a specific financial industry—the clearing and settlement (C&S) industry. C&S institutions are the crucial and indispensable infrastructure undergirding all modern financial markets. Clearinghouses operate as central conduits transferring assets and securities among trading parties, to wit, they perform post-trade operations when two counterparties have entered into an agreement.[15] This critical industry is deeply affected by the new coordinative decision making and, hence, potentially exposed to *collectivism*. The new rules tie together the jurisdiction and philosophy of several regulators, including, inter alia, the SEC, the CFTC, and the Fed.[16] The Article demonstrates that such "innovation" may be suboptimal.

The principal reason is that, as I show in this Article, the SEC, acting as a centralized, functional regulator, was able to forge a remarkably successful cooperation with the clearing industry in the securities and options markets.[17] In doing so, it followed the industry's lead and promoted the best practices suggested by the industry in the

15 *See generally* Colleen Baker, *The Federal Reserve as Last Resort*, 46 U. MICH. J.L. REFORM 69, 98–104 (2012) (discussing specifically the functions of the central counterparty clearinghouses); Neal L. Wolkoff & Jason B. Werner, *The History of Regulation of Clearing in the Securities and Futures Markets, and Its Impact on Competition*, 30 REV. BANKING & FIN. L. 313, 316 (2010) (reviewing the functions of clearinghouses); Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29510 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240); discussion *infra* Section II.A.

16 *See* Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29511–13 (discussing coordination policies); Omarova, *supra* note 8, at 151–57.

17 *See* discussion *infra* Section II.B, Parts III–IV.

first place. The relationship between the regulator and the regulated was unidirectional (i.e., it was primarily between the SEC and the clearing agencies). In other words, it was *linear*.

The Article will identify the four postulates and principles of this successful linear interaction model.[18] Within this unidirectional model, the sector-specific regulator relied heavily on clearinghouses' initiatives and provided constructive support to the ongoing market evolution.[19] Such cooperative interaction between one regulator, the SEC, and one regulated market not only targeted regulatory inefficiencies but also contributed to the clearing industry progress, low costs, and dynamic efficiency.[20]

Various studies confirm the comparative cost efficiency of U.S. C&S facilities vis-à-vis those in other jurisdictions, including European markets,[21] where regulations are much more fragmented and at the

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18 In a nutshell, the *first* postulate was the efficiency-maximizing regulatory flexibility and principles-based regulations, strengthening the operational discretion and freedom granted to clearing agencies in shaping their internal policies. Over the course of almost forty years, the SEC operated as a relatively predictable umbrella regulator. Its principles-based policies focused on the standards that generally complied with what the market itself demanded of clearinghouses. As such, the regulations were framed within the market-regulator, impetus-reform pattern. The *second* supporting postulate was the noninterventionist enforcement policies of the SEC. *Third*, the regulator-market interaction relied on the predictability of litigation outcomes and dispute resolution. The assembled database of all cases involving C&S facilities illustrates an unequivocal and almost invariable judicial support of clearinghouses and significant deference to the pertinent SEC regulations. *Finally*, the market-regulator equilibrium was reached through continuous market self-monitoring through the participatory corporate governance mechanisms. Its structural support beam was the contestable monopoly pressures within the industry. *See infra* Section II.B.

19 In this sense, I agree with Manne and Zywicki who build on Alchian's evolutionary model and distinguish between *absolute* inefficiency and *relative* efficiency of market arrangements. The difference is, of course, that the equilibrium discussed in this Article incorporates the SEC as an additional evolutionary actor. Geoffrey A. Manne & Todd J. Zywicki, *Uncertainty, Evolution and Behavioral Economic Theory*, 10 J.L. ECON. & POL'Y 555, 557 n.7, 560 (2014).

20 *See* discussion *infra* Part II.

21 *See e.g.*, EUROPEAN CENT. BANK, FINANCIAL INTEGRATION IN EUROPE 55–57 (2010), http://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201004en.pdf (mentioning higher C&S costs within the EU); NERA ECON. CONSULTING, THE DIRECT COSTS OF CLEARING AND SETTLEMENT: AN EU-US COMPARISON (2004), http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/2007-2000/direct-costs-of-clearing-and-settlement-executive-summary.pdf; Baris Serifsoy & Marco Weiß, *Settling for Efficiency—A Framework for the European Securities Transaction Industry*, 31 J. BANKING & FIN. 3034, 3035 (2007) (mentioning that the European market was at a relative disadvantage because of higher costs); Patrick van Cayseele & Raad voor de Mededinging, *Competition and the Organisation of the Clearing and Settlement Industry* 8–9 (Ctr. for Econ. Studies, Discussions Paper Series No. 04.13, 2004), http://feb.kuleuven.be/eng/ew/discussionpapers/Dps04/Dps0413.pdf (discussing relevant studies).

In the past several years, the costs in the EU have been steadily decreasing. *See, e.g.*, OXERA CONSULTING, MONITORING PRICES, COSTS AND VOLUMES OF TRADING AND POST-TRADING SERVICES 31, 34 (2011), http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2011_oxera_study_en.pdf. However, a number of structural problems remain and it is same time more *collectivist* than in the United States.[22] European researchers naturally look to the U.S. experience for guidance in policymaking.[23] Similarly, while several clearinghouses around the world fell at different points in time, the U.S. clearing industry has shown strong survival skills and, most importantly, performed well during the recent crisis.[24]

Considering these arguments and the dangers of *collectivism*, this Article will suggest that Dodd-Frank put forth a questionable approach to reforming—at the very least—*successful* industries, which were not implicated in the crisis. Unnecessary reforms make industry success stories transitory as compliance costs go up. There are already reasons to believe that clearing costs may be increasing due to the new

questionable whether the low cost model is sustainable without further industry changes. Michael Albanese, *Competition, Consolidation and Change: Key Considerations in European Securities Clearance*, PERFORMANCE, Jan. 2014, at 68–73, http://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/lu-key-considerations-european-securities-clearance.pdf; Shaofang Li & Matej Marinč, Competition in the Clearing and Settlement Industry, J. INT'L FIN. MARKETS, INSTITUTIONS & MONEY, Jan. 2016, at 134.

22 *See supra* note 10 and accompanying text.

23 *See, e.g.*, ANGELO BAGLIONI & RONY HAMAUI, BANCA INTESA, THE INDUSTRIAL ORGANIZATION OF POST-TRADING 4–5, 14 (2006), http://www.group.intesasanpaolo.com/scriptIsir0/si09/storici/studi/eng_st_collRic_bin.jsp#/storici/studi/eng_st_collRic_bin.jsp (discussing various reforms based on a comparison with the United States); PETER COX ET AL., BOURSE CONSULT, THE FUTURE OF CLEARING AND SETTLEMENT IN EUROPE app. C (2005), http://bourse-consult.com/wp-content/uploads/2014/03/FutureofClearingSettlementFinal.pdf (comparing United States and EU clearing); POLICY DEP'T A: ECON. & SCI. POLICIES, EUROPEAN PARLIAMENT, CLEARING AND SETTLEMENT IN THE EU 42 (2009), http://www.augurproject.eu/IMG/pdf/Clearing_and_Settlement_in_the_EU-WP2.pdf (discussing the establishment of a single pan-European CCP, which, of course, is similar to the course of action adopted in the United States, as discussed *infra* Part III); EUROPEAN SEC. FORUM, EUROCCP: ESF'S BLUEPRINT FOR A SINGLE PAN-EUROPEAN CENTRAL COUNTERPARTY 4 (2000), http://www.csdl.lt/en/data/legal/inter/2_Blueprint_pdf_as_of_11dec.pdf ("[I]t is possible to look at the analogous U.S. situation in the early 1970s.").

The European regulators and C&S facilities replicated some SEC reforms, including, for instance, clearinghouse interoperability and transparency, as a direct result of which, post-trading fees have decreased, almost reaching U.S. levels. *See, e.g.*, MIKE REECE, J.P. MORGAN, COMPETITION OR CONSOLIDATION? THE OUTLOOK FOR INTEROPERABILITY AMONG EUROPEAN CCPS (2012), https://www.jpmorgan.com/cm/BlobServer/Competition_or_Consolidation_The_Outlook_for_Interoperability_Among_European_CCPspdf.pdf?blobkey=id&blobwhere=1320549706572&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs; Albanese, *supra* note 21, at 69–70.

24 *See, e.g.*, Griffith, *supra* note 12, 1350 n.285 (mentioning the failures); Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 227 (2013) (discussing examples of failures, including near failures in derivative markets, but not securities markets); Letter from James E. Brown, Exec. Vice President, Gen. Counsel & Sec'y, Options Clearing Corp., to Kevin O'Neill, Deputy Sec'y, Sec. & Exch. Comm'n 3 (May 27, 2014) [hereinafter 2014 OCC Letter], https://www.sec.gov/comments/s7-03-14/s70314-15.pdf (discussing the OCC's stability throughout the crisis).

regulations.[25] Higher costs and the expanding palette of global markets may break the already faltering leadership of U.S. trading venues.[26] These are the crucial reasons to caution postcrisis regulators against unnecessary tempering with the long-term status quo in cases where a cooperative market-regulator relationship existed before the crisis.

This Article proceeds as follows: Parts I and II outline potential problems associated with collectivism and set forth the *four postulates* (i.e., the fundamental principles) of the traditional cooperative model in the clearing and settlement industry. Part III provides illustrations of the model's postulates and reviews the C&S industry's structure, risks, and the existing risk-mitigation arrangements. Part IV discusses ex post "regulatory reaction" (i.e., enforcement actions and pertinent case law). It reviews major SEC actions and all cases involving clearing institutions. Part V contrasts the new reforms with the traditional four-postulate equilibrium.

I. COORDINATION AND COLLECTIVISM

Regulatory systems may be classified along various dimensions. In summary, the major taxonomies of regulatory approaches are as follows: (1) mandatory and monopolistic or competitive; (2) harmonized or uniquely divergent, an ever more unusual characteristic; and (3) diffused along industry functions (i.e., sector-specific and institutional) or integrated under the umbrella of a single regulator or two regulators. The mechanics and pros and cons of these approaches have been extensively explored in the literature[27].

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25 Some of these processes in clearing may already be happening. *See, e.g.*, 2014 OCC Letter, *supra* note 24, at 13 (mentioning that the OCC eliminated certain fee discounts to increase its liquid net assets under the new rules).

26 *See, e.g.*, Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1435–37 (2008).

27 On the first dimension of this debate, see, for example, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 218–23 (1991) (discussing charter competition arguments); Romano, *supra* note 2 (arguing for regulatory diversity in international financial regulations); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2363–92 (1998) [hereinafter Romano, *Empowering Investors*] (discussing arguments in favor of regulatory competition); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 390–99 (2001); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254–62, 289–91 (1977) (making a case for the traditional state corporate law approach versus federalization); Roberta Romano, *The Market for Corporate Law Redux* (European Corp. Governance Inst., Law Working Paper No. 270, 2014) (discussing the benefits of competition). *But see* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 999 (2012) (implying, generally, that the race to the bottom is possible in a competitive regulatory environment and mentioning that "it is also possible that firms with high agency costs—those

The risk of *collectivism* is a derivative of several approaches. Recall that this Article generally defines *collectivism* as a destructive outgrowth of rule harmonization, excessive regulatory coordination, and the power of a third regulator or a number of regulators to intervene and change

that need regulation the most—will make the choices that are not socially desirable"); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) (discussing the race for the top and the race for the bottom arguments, as well as managers' opportunism); Lucian Arye Bebchuk & Assaf Hamdani, Essay, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002) (discussing why state competition can lead to inefficient results); James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200 (1999) (criticizing regulatory competition arguments and advocating a more coordinated approach with the leadership of the SEC); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (discussing the bias towards underdisclosure and generally making a case for mandatory, centralized regulations to provide disclosure at the optimal level); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775 (2006) (focusing on the reputational constraints of the capital market gatekeepers and the need for a strong regulatory agency); Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1384–92, 1431 (discussing the race to the top and the race to the bottom arguments, as well as providing harmonization supporting arguments); Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation*, 39 GA. L. REV. 525 (2005) (distinguishing the charter competition from other areas of law on the grounds of, inter alia, the adaptation of the regulators and the regulated to a monopoly environment, expertise of the local interest groups).

On the second dimension of the debate, the benefits, costs, and international developments in regulatory harmonization, substituted compliance arguments, compatibility approaches, and mutual recognition, see generally JOHN F. MORRALL III, U.S. CHAMBER OF COMMERCE, DETERMINING COMPATIBLE REGULATORY REGIMES BETWEEN THE U.S. AND THE EU (2011), https://www.uschamber.com/sites/default/files/legacy/reports/Determining%20Compatible%20Regulatory%20Regimes.pdf; Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 HARV. INT'L L.J. 105 (2007); Christian Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd-Frank: The Implications of US Global OTC Derivative Regulation*, 14 NEV. L.J. 542 (2014) [hereinafter Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd-Frank*] (weighing harmonization efforts against regulatory arbitrage); Press Release, U.S. Commodity Futures Trading Comm'n, The European Commission and the CFTC Reach a Common Path Forward on Derivatives (July 11, 2013) [hereinafter 2013 CFTC Press Release], http://www.cftc.gov/PressRoom/PressReleases/pr6640-13; sources cited *supra* note 12.

The final dimension of this debate is regulatory consolidation versus the "legacy approach" to regulation, i.e., institutional, functional, and sector-specific regulation. *See generally* GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION, *supra* note 3, at 33–39 (assessing the four structural approaches to financial supervision); Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1 (2005); Elizabeth F. Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom, and Australia*, 55 VILL. L. REV. 509 (2010); Cunningham & Zaring, *supra* note 1, at 42, 51, 112–13 (mentioning that there are traditional benefits associated with fragmentation); David T. Llewellyn, Institutional Structure of Financial Regulation and Supervision: The Basic Issues, *in* ALIGNING FINANCIAL SUPERVISORY STRUCTURES WITH COUNTRY NEEDS 17 (Jeffrey Carmichael et al. eds., 2004) (suggesting more consolidated approaches in light of the expanding nature of the financial industry); Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 36 (2010) (arguing against the functional approach and advocating for a more holistic one).

the policies of an expert regulator. As discussed, *collectivism* may be described as a regulatory risk of a decision-making system where a more powerful agency or a group of agencies may impel a less influential regulator to unnecessarily modify its rules and regress to the mean (i.e., to average and generic rules). *Collectivism* thus may result in unnecessary regulations, which are not based on either the better expertise of individual regulators or the industry needs.

Arguably, without destructive collectivist consequences, coordination and harmonization may be defended on the grounds of reducing information losses, regulators' "myopia," and regulatory arbitrage. For one, a reduction in information asymmetry may ensure a smooth and well-informed regulatory intervention, particularly, during or before a crisis.[28] Indeed, fragmented agencies, such as the SEC, were blindsided by the systemic risk posed by the multifaceted operations of some financial institutions in 2007–2008. The crisis also highlighted the fact that market actors simply do not always act in a manner consistent with social welfare maximization and are prone to avoid regulations in order to reduce associated costs.[29]

Sometimes, mistakes happen regardless of the specific firms' incentives, as multiple individual—but interconnected—financial firms inadvertently misprice negative externalities in selecting optimal risk levels.[30] Thus, due to information losses, the interconnected nature of modern financial institutions, and their misbehavior, enhanced systemic supervision and some sort of interagency coordination or consolidation may be warranted.[31]

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28 *See, e.g.*, Joseph Stiglitz, *Must Financial Crisis Be this Frequent and this Painful*, *in* POLICY OPTIONS: TAMING WORLD CAPITAL 23, 24–25 (William Watson ed., 1999) (discussing the lack of information in the market and justification for some form of government intervention).

29 *See, e.g.*, Coffee & Sale, *supra* note 4, at 731–40 (discussing the crisis, investment banks' preference for the relaxed SEC supervision under the Consolidated Supervised Entity Program, and inadequate oversight issues); Cunningham & Zaring, *supra* note 1, at 59–69 (discussing market failures and ex post regulatory responses); Gadinis, *supra* note 7, at 346–48 (reviewing some examples of market failures); Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1343–63 (2009) (emphasizing the continuous origination of risky mortgages against insufficient regulatory supervision).

30 *See, e.g.*, Whitehead, *supra* note 12, at 358.

31 *See, e.g.*, DEP'T OF THE TREASURY, BLUEPRINT, *supra* note 3; Coffee & Sale, *supra* note 4, at 738–49, 774–79 (discussing the Consolidated Supervised Entity Program, the SEC's insufficient expertise to oversee major investment banks, and regulatory consolidation arguments); Cunningham & Zaring, *supra* note 1, at 51 ("A fragmented structure may enable authorities to respond to discrete institutional failures using tailored tools, but it may also blind senior regulators to important systemic risks that lead to widespread crisis. The question becomes the net value of disaggregation, an industry-by-industry focus, and redundancy with gaps, or whether consolidation is likely to result in better regulatory performance in crises, as by reducing their magnitude or duration."). Acknowledging these structural issues, many

Yet one must acknowledge that having a more consolidated or coordinated regulatory system is not a supervisory panacea for reducing information losses. Consider, for instance, that the Fed's authority had been expanded already in the Gramm-Leach-Bliley-Act era.[32] Yet it missed the impending crisis, just like the sector-specific SEC. Similarly, the EU experience has demonstrated that integrated and twin peaks approaches to financial supervision do founder. The integrated regulators in Europe failed to insulate their financial markets from being engulfed by the crisis and to detect systemic risk before the crisis hit. Later on, they did not fare better than the more fragmented U.S. regulators in their response to the financial calamity.[33]

Perhaps a more important theoretical concern is that coordination, consolidation, and harmonization are not bound to reduce information losses or to improve regulatory oversight. Obviously, all regulatory agencies, consolidated or fragmented, may be castigated as imperfect and occasionally myopic.[34] More importantly, if a regulatory system is monopolistic, coordinated, and harmonized, and at the same time lacks continuous market input, it may be inferior to regulatory competition and diversity of approaches, become a source of deadweight losses, or propagate systemic mistakes among subscribers to a centralized or harmonized regime.[35] In addition, in the words of Charles Whitehead, harmonized approaches may channel disastrous market behaviors through "destructive coordination."[36] The information loss explanation and the better-coordinated oversight story, therefore, are not

countries opted for "councils" of regulators as an interim solution in the wake of the crisis. Gadinis, *supra* note 7, at 365–71. The proposed rule on clearinghouses also relies on coordination arguments. Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240); *see also* Robert Hockett, *Bubbles, Busts, and Blame?*, CORNELL L. F., Spring 2011, http://forum.lawschool.cornell.edu/Vol37_No1/Feature-4.cfm.

32 *See, e.g.*, McCoy et al., *supra* note 29, at 1344–51 (discussing the two-sided effect of the statutory reform on the authority and functions of the Fed, as well as related ideological blinders).

33 One may doubt whether regulatory consolidation equals systemic risk "prescience." *See, e.g.*, GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION, *supra* note 3, at 49 (mentioning the problems experienced by the United Kingdom, a country with a more consolidated oversight structure, and observing that that "notwithstanding its somewhat dated and complex regulatory structure, U.S. regulators have been viewed by some as responding in a timely and aggressive manner to recent conditions"); Cunningham & Zaring, *supra* note 1, at 108–09 ("[E]xperience does not demonstrate superiority of the two-peaks model compared to alternatives, including the battle-tested traditional fragmented U.S. approach.").

34 For instance, regulators may, inter alia, ignore or miss the red flags raised by researchers, the propensity emphasized in a study by Macey and O'Hara. *See* Jonathan R. Macey & Maureen O'Hara, Essay, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89 (2009).

35 *See generally* Romano, *Empowering Investors*, *supra* note 27; Whitehead, *supra* note 12; Romano, *Iron Law of Financial Regulation*, *supra* note 2.

36 *See generally* Whitehead, *supra* note 12.

irrefragable. Yet, after Dodd-Frank, regulators seem to have presumed these benefits of harmonization and coordination without question, as nearly axiomatic.[37]

As mentioned above, the second key argument in defense of consolidation and harmonization is the race to the bottom and regulatory arbitrage concerns.[38] For the purposes of this analysis, that scholarship may be distinguished. The historical stability of the model presented in this Article and the limited role of clearinghouses as financial market utilities, serving predominantly domestic trading, suggest that these processes may be controlled by internal mechanisms. Thus, the arbitrage and race to the bottom phenomena are less likely than in some other industries.[39]

Now, let us turn to the potential collectivist dangers of Dodd-Frank overcoordination. Consider first that in attempting to mitigate the flaws of sector-based regulations, Dodd-Frank stops short of consolidating the regulatory system. Leaving aside for the moment the innate pros and cons of consolidation, it should follow naturally that a *less* consolidated organizational structure may reduce information losses *less* than a fully consolidated one. What if instead of battling myopia, the new decision-making rules entail regulatory procrastination due to the sequential involvement of several agencies and increased coordination costs?[40] On balance, this result is also possible.

Second, in the extreme scenario, the multiactor regulatory edifice may fall prey to the "regulatory commons problem," a "political economic incentive[] . . . to leave social ills unaddressed" in a multilayered legal system.[41] Dodd-Frank's mandate to work together on curing social ills may not entirely remove the regulators' natural propensity to shirk for political and other reasons in a multilayered,

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37 *See, e.g.*, Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29512–14, 29577–79, 29587–88, 29590 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240).

38 *See, e.g.*, *id.* at 29577–29590; Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2012) (discussing, generally, the notion of regulatory arbitrage and how arbitrage may in certain cases reduce social welfare); Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd-Frank*, *supra* note 27; 2013 CFTC Press Release, *supra* note 27.

39 *See, e.g.*, Yadav & Turing, *supra* note 10, at 38 (suggesting similarly that the differences in regulations are more likely to lead to market choices than a true race to the bottom).

40 For a review of the prohibitive coordination costs, and integrated regulation benefits and downsides arguments, see, for example, Dan Awrey, *The FSA, Integrated Regulation, and the Curious Case of OTC Derivatives*, 13 U. PA. J. BUS. L. 1, 9–17 (2010); *see also* Bressman & Thompson, *supra* note 7, at 615 ("Political pressure might cause the SEC to steer securities policy away from the SROs toward federal intervention. Or it might cause the SEC to delay when federal intervention is necessary to prod the SROs."); William W. Buzbee, *Recognizing the Regulatory Commons: A Theory of Regulatory Gaps*, 89 IOWA L. REV. 1, 36 (2003) (discussing the coordination costs).

41 Buzbee, *supra* note 40, at 5.

underconsolidated system.[42] Consequently, on the one hand, experience demonstrates that consolidation is no panacea. On the other hand, underconsolidation poses dangers of its own.

In addition to the foregoing dangers, the reforms do not fully address a host of behavioral and structural issues highlighted by previous research. Those problems range from the cognitive limitations and behavioral biases of the regulators, their propensity to preserve the status quo and potential industry capture, to their lack of resources and expertise contrasted with the market self-regulatory and institutional mechanisms.[43]

For instance, as I further show in this Article, the pressures of Dodd-Frank collectivism are forcing the SEC to reduce the clearing industry's discretion.[44] Alas, less discretion may be correlated with a reduced self-regulatory potential and may stifle market experimentation. Similarly, the regulatory capture risk may be aggravated by the involvement of the Treasury and politicians in the actions of the formerly independent agencies. Namely, while "a regime that puts politicians at the helm creates greater incentives for financial firms to strengthen their relationships with future regulators,"[45]

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42 *Id.* at 49–51.

43 *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 308–09 (2000) (mentioning regulators' incentives "to entrench the regulatory status quo" resulting in outdated rules); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 20–36 (2003) (reviewing various potential biases of the SEC); James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 752 (2009) (underscoring the inherent limitations of quantitative risk management of complex financial institutions and information asymmetry issues affecting the regulators and the regulated); Gadinis, *supra* note 7, at 348–50 (discussing regulatory capture); Tom C.W. Lin, *The New Financial Industry*, 65 ALA. L. REV. 567, 593 (2014) (discussing how law lags behind financial developments); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 922–23 (1994); Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639 (2010); Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315; Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 488–93 (2007) (discussing institutional and informational limitations of the regulators); McCoy et al., *supra* note 29; A.C. Pritchard, *The Sec at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1077–92 (2005) (cataloguing behavioral biases of the SEC, regulatory overreaction to crises, regulatory capture, and other issues undermining the SEC's efficiency); Geoffrey Christopher Rapp, *Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 BYU L. REV. 73, 136–40 (discussing resource limitations and regulatory capture concerns).

44 *See, e.g.*, Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29576, 29587–88 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240).

45 Gadinis, *supra* note 7, at 385. *But see* Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245 (2001) (generally approving the presidential administration and the increased involvement of presidents in the actions of regulatory agencies).

independent agencies, by contrast, are bound by explicit rules of administrative law. They, ex hypothesi, may be less susceptible to selective favoritism.[46]

If stronger and more politically influential agencies within a group are "captured," two scenarios are plausible: The leaders may not promote regulations objectively needed by the weaker members. Namely, if the strong members are captured by wrong private constituencies, the outsiders will have to live with the rules tailored to and by those constituencies. The second issue is that the information input from the outsiders will be either lost or improperly integrated within the "captured" regulations.

Finally, the group dynamics of Dodd-Frank overcoordination may theoretically open the door to possible jawboning and maneuvering by the more politically influential agencies, such as the Treasury and the Fed. The mirror image of this problem is the SEC's regulatory concessions and political strategizing in an attempt to avoid confrontation. Previous research suggests these possible complications.[47] As I explore in Part V, the SEC is already making such concessions and modifying its rules in accordance with the policies of third-party regulators, often without providing cogent explanations of the need for the changes.

The other facet of the same trend is possible coalition building within the FSOC itself and its effect on individual agencies, which are weaker group members. Different sector-based regulators, in theory, may engage in lobbying efforts in order to promote their individual philosophies and agendas.[48]

By way of example, as discussed further in this Article, the CFTC's and the SEC's approaches to regulating clearinghouses differ in the level of their rigidity and prescriptiveness. The SEC remains more principles based, which the major clearinghouses acknowledge and welcome.[49] In case of an extreme disagreement, the specter of regulatory turf wars and

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46 *See, e.g.*, Cunningham & Zaring, *supra* note 1, at 50; Gadinis, *supra* note 7, at 386 (discussing the Wall Street bailouts and mentioning that "[b]ureaucrats, whether public-interest-minded civil servants striving to implement technical orthodoxies or biased sheriffs fresh out of the industry's revolving door, are supposed to follow rules and procedures and to apply them uniformly to all participants in the industry," while politicians are more prone to building "diverse alliances"); *see also* Administrative Procedure Act, 5 U.S.C. §§ 551–559; 561–570a (2012).

47 *See, e.g.*, Bressman & Thompson, *supra* note 7, at 643–46 (reviewing instances of political influence); Gadinis, *supra* note 7, at 370 (discussing the pivotal role of the Treasury Secretary in the FSOC).

48 *See, e.g.*, Bressman & Thompson, *supra* note 7, at 643 (expressing similar concerns regarding the first proposals by the Obama Administration and noting that "[w]hen agencies like the SEC and the CFTC split on an issue, each will seek to persuade others on the council to support its position. It seems likely that the Secretary will be first among equals in this setting").

49 *See* discussion *infra* Part V.

coalition building may loom on the horizon, urging a rational policymaker to promote peace.

To this end, an agency may purposely regress to the mean and promulgate generic rules that are acceptable to all regulators. In this process, the agency may perforce or inadvertently disregard the crucial information input provided by the regulated market. Part V will provide examples of such first "average" regulations.

Current overcoordination coupled with the effective veto power of the Fed and the FSOC over the decisions of sector-specific regulators seem to invite all of these problems. Hence, the Dodd-Frank decision making *may* produce *collectivist* repercussions undermining the Act's intended value as a coordination and information device, solidifying "average" and unnecessary regulations, and curtailing market discretion. The costs of these repercussions may exceed the expected economic benefits of the new rules, particularly in cases where a precrisis regulatory approach did not explicitly call for reform in the first place.

Although developing a solution is beyond the scope of this Article, a brief sketch of some ideas may be instructive. Namely, it would be better if the reformers promoted less intrusive coordination and information-sharing devices. For instance, the President's Working Group had been in existence long before Dodd-Frank,[50] and indeed helped sector-specific regulators and the Fed improve communication during the crisis.[51] Building on these information exchange mechanisms among various sector-based independent agencies and the Fed, and promoting basic cooperation, may be preferable to more intrusive overcoordinated decision making.

Unfortunately, these changes require statutory action, which is currently unlikely. A simpler way to address the problem is through policy signaling. The Fed—and by extension the FSOC—may deliberately signal that it would exercise its statutory authority and intervene in sector-specific rulemaking only in extreme circumstances.

Similarly, expert agencies, such as the SEC, must ensure that the post–Dodd-Frank changes do not spill over into the regulation of successful financial industries that were not the root causes of the crisis. Those precrisis regulations that were traditionally based on an efficient interaction between the SEC, as an individual functional regulator, and the regulated industries have to be preserved and guarded against either

50 The Group included the SEC, the Fed, the Treasury, the CFTC, and other entities. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-00-46, FINANCIAL REGULATORY COORDINATION: THE ROLE AND FUNCTIONING OF THE PRESIDENT'S WORKING GROUP 1–2, 18–19 (2000) [GAO, FINANCIAL REGULATORY COORDINATION], http://gao.gov/assets/230/228743.pdf.

51 Cunningham & Zaring, *supra* note 1, at 77–79 (discussing the input of the Group and its coordinating activities during the 2008 crisis).

the influence of other sector-specific regulators, such as the CFTC, or the Fed. An example of such an industry is clearinghouses.

II. The Four Postulates of a Successful Linear Market-Regulator Cooperation

A. *Clearing and Settlement*

The C&S industry is uniquely situated in the postcrisis era: It was not among the underlying causes of the crisis and yet it is affected by the resultant regulations. Therefore, the industry represents a perfect natural experiment where the logic of pre- and postcrisis regulations can be evaluated impartially. To put it plainly, choosing clearing and settlement as an example allowed me to focus on the actual dynamics of the pre- and postcrisis interactions between the regulators and the clearinghouses. Accordingly, we may disregard the political sentiment and inefficiencies associated with the typical crisis culprits like credit default swaps, failed investment banks, or mortgage-backed securities.[52]

Despite their somewhat low profile during the crisis, clearinghouses are among the major and most important market participants. Indeed, when traders enter into transactions, each transaction must be cleared and settled. "Clearing" of securities and derivatives trades is a complicated process, which involves trade processing, comparison, matching, confirmation, registration, netting, and risk management, including collateralization and margining.[53]

Many clearing institutions are "central counterparties" (CCPs), which offer a variety of services that streamline the clearing process.[54] CCPs' principal services include, inter alia, contractual novation,[55] multilateral netting services,[56] and risk management through collateral

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52 *See, e.g.*, Coffee & Sale, *supra* note 4, at 731–48; Gadinis, *supra* note 7, at 345–51 (discussing various failed institutions and related policy concerns).

53 *See generally* TINA P. HASENPUSCH, CLEARING SERVICES FOR GLOBAL MARKETS 17–40 (2009); Yuliya Guseva, *KGB's Legacy: Transplanting Efficient Financial Infrastructures Without Efficiency*, 36 U. PA. J. INT'L L. 525, 548–49 (2015); John McPartland, *Clearing and Settlement Demystified*, CHI. FED. LETTER, Jan. 2005, https://www.chicagofed.org/publications/chicago-fed-letter/2005/january-210.

54 *See, e.g.*, CPSS-IOSCO, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES, *supra* note 12, at 8–9; Robert R. Bliss & Robert S. Steigerwald, *Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures*, ECON. PERSP., 4Q 2006, at 22–25; Mark J. Roe, *Clearinghouse Overconfidence*, 101 CALIF. L. REV. 1641, 1657–61 (2013).

55 CPSS-IOSCO, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES, *supra* note 12, at 9.

56 *Id.* at 9, 24; *see also* Kirsi Ripatti, *Central Counterparty Clearing: Constructing a Framework for Evaluation of Risks and Benefits* 11–12 (Bank of Fin., Discussion Paper No. 30, 2004), http://ssrn.com/abstract=787606.

and margin requirements, participation standards, and guarantee funds.[57] Importantly, a CCP acts as a buyer and seller in each trade and substitutes itself for the original counterparties.

Another side of C&S is "settlement," "the process whereby parties discharge their contractual obligations to pay cash or deliver securities" or other assets.[58] In the securities markets, settlement and depository services are facilitated by central securities depositories (CSDs), which interface with CCPs.[59]

All these financial market infrastructures are "clearing agencies." The Securities Exchange Act of 1934 (Exchange Act) defines a clearing agency as "any person who acts as an intermediary . . . in connection with transactions in securities or who provides facilities for comparison . . . , to reduce the number of settlements . . . or for the allocation of securities settlement responsibilities."[60]

The current policy consensus is that centralized clearing infrastructures are more efficient risk bearers and more transparent and cost-efficient conduits than contracting parties settling their trades.[61] To recap, the pertinent risk-management mechanisms range from setting membership standards, collecting collateral, establishing default funds, netting, and reducing payment demands on members, to monitoring their conduct.[62]

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57 *See generally* DIV. OF MKT. REGULATION, U.S. SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK ch. 10 (1988) [hereinafter U.S. SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK], http://www.sechistorical.org/museum/search/?q=october+market+break&begin=0; DARREL DUFFIE ET AL., FED. RESERVE BANK OF N.Y., POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE 7–9 (2010), http://www.newyorkfed.org/research/staff_reports/sr424.pdf; Guseva, *supra* note 53, at 548–49; Raymond Knott & Alastair Mills, *Modeling Risk in Central Counterparty Clearing Houses: A Review*, *in* FINANCIAL STABILITY REVIEW 162, 162–64 (2002), http://www.jscc.co.jp/en/data/2.pdf; Griffith, *supra* note 12, at 1312–16; Craig Pirrong, *The Industrial Organization of Execution, Clearing and Settlement in Financial Markets* 6–8 (Ctr. for Fin. Studies, Working Paper No. 2008/43, 2007), http://econstor.eu/bitstream/10419/43251/1/599235586.pdf ; Ripatti, *supra* note 56 , at 10–24.

58 Pirrong, *supra* note 57, at 8.

59 *See, e.g.*, Order, Exchange Act Release No. 20221, 48 Fed. Reg. 45167-02, 45170–71 (Sept. 23, 1983) (discussing depositories); DEPOSITORY TR. CO., RULES, BY-LAWS AND ORGANIZATION CERTIFICATE 44–48 (2015) [hereinafter DEPOSITORY TR. CO., RULES, BY-LAWS AND ORGANIZATION CERTIFICATE], http://www.dtcc.com/~/media/Files/Downloads/legal/rules/dtc_rules.pdf (describing DTC services).

60 15 U.S.C. § 78c(a)(23)(A) (2012); *see also* 7 U.S.C. § 1a(15)(A) (2012) (defining "derivatives clearing organization").

61 *See, e.g.*, Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29510–11 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240) (accepting some benefits as a given in the swap clearing context); Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66264 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

62 *See, e.g.*, Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29510–11, 29511–13, 29522–23, 29585; BAGLIONI & HAMAUI, *supra* note 23, at 7 (discussing the benefits of a single clearinghouse); CPSS-IOSCO, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES, *supra* note 12, at 8–9; Knott & Mills, *supra* note 57 (generally discussing risk management procedures

At the same time, centralized clearing poses a number of profound risks.[63] Whenever C&S services are concentrated or interconnected, the risks of CCPs and related depositories are potentially massive. For instance, recall that a CCP provides a guarantee of trade completion to buyers and sellers. Hence, while CCPs mitigate the counterparty risk, they also mutualize and concentrate risks and may expose nondefaulting participants to other members' defaults.[64] Considerable market disruptions may follow if risks are improperly managed, particularly, by sizeable clearinghouses. Consider, for instance, what might happen in the case of the Depository Trust and Clearing Corporation (DTCC), a large holding company for clearing agencies, which "reported processing $1.6 quadrillion in transactions in 2012."[65]

Mismanagement of risk may result from typical endogenous causes, such as moral hazard or flawed corporate governance, and from exogenous events, including court decisions or regulatory reforms. By way of example, as emphasized in a CCP's affidavit submitted in a 1987

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and future risks); Ben S. Bernanke, *Clearing and Settlement During the Crash*, 3 REV. FIN. STUD. 133, 136–37 (1990), http://www.jscc.co.jp/en/data/5.pdf; Yee Cheng Loon & Zhaodong Ken Zhong, *The Impact of Central Clearing on Counterparty Risk, Liquidity, and Trading: Evidence from the Credit Default Swap Market*, 112 J. FIN. ECON. 91, 98–100, 116, 126 (2014) (suggesting counterparty and systemic risk reduction); Ripatti, *supra* note 56, at 43–44, 50 (discussing the pros and cons of CCPs); Squam Lake Working Grp. on Fin. Regulation, *Credit Default Swaps, Clearinghouses, and Exchanges* 3–4 (Council on Foreign Relations, Working Paper, 2009), http://www.cfr.org/financial-crises/credit-default-swaps-clearinghouses-exchanges/p19756; Yadav & Turing, *supra* note 10, at 8–10 (discussing the benefits of clearinghouses and related risk-mitigation mechanisms); Jill E. Sommers, Comm'r, U.S. Commodity Futures Trading Comm'n, Remarks Before the Capital Markets Consortium: Clearinghouses as Mitigators of Systemic Risk (Sept. 30, 2010), http://www.cftc.gov/PressRoom/SpeechesTestimony/opasommers-10.

63 That is why the consensus has its critics, including Craig Pirrong, Sean Griffith, and Mark Roe, arguing, in particular, against the systemic risk reduction presumption associated with centralized clearinghouses. *See* Roe, *supra* note 54, at 1645, 1675–90; Craig Pirrong, The Economics of Clearing in Derivatives Markets: Netting, Asymmetric Information, and the Sharing of Default Risks Through a Central Counterparty 54–62 (Jan. 8, 2009) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1340660; *see also* Knott & Mills, *supra* note 57, at 172 (summarizing the pros and cons); Ripatti, *supra* note 56, at 44–50 (same); Squam Lake Working Grp. on Fin. Regulation, *supra* note 62, at 4–6 (same).

64 *See, e.g.*, U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-97-73, PAYMENTS, CLEARANCE, AND SETTLEMENT: A GUIDE TO THE SYSTEMS, RISKS, AND ISSUES 47–57, 74–76, 89–90 (1997) [hereinafter GAO, PAYMENTS, CLEARANCE, AND SETTLEMENT], http://www.gao.gov/assets/230/224212.pdf (summarizing C&S risks); DUFFIE ET AL., *supra* note 57, at 24 (discussing "waterfall" structures); Darrell Duffie & Haoxiang Zhu, *Does a Central Clearing Counterparty Reduce Counterparty Risk?*, 1 REV. ASSET PRICING STUD. 74, 75–76, 78–81 (2011) (discussing CCP risks and comparing counterparty default exposure in systems with multiple CCPs and a single CCP); John P Jackson & Mark J Manning, *Comparing the Pre-Settlement Risk Implications of Alternative Clearing Arrangements* 8–10 (Bank of Eng., Working Paper No. 321, 2007), http://www.bankofengland.co.uk/research/Documents/workingpapers/2007/WP321.pdf (discussing risk reduction and margining in the context of various multilateral clearing and membership structures).

65 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29575–76.

Delaware case, unwinding $1.6 billion of trades in the securities of a tender offer target could result in a massive market disruption and losses to unrelated third parties participating in the largest CCP in the United States.[66]

Liquidity problems and potential contagion of defaults are other concomitant concerns.[67] Another powerful argument is that centralized clearing may fail to ensure proper risk monitoring, while external market monitoring may be potentially weakened by moral hazard and adverse selection.[68]

These and other germane concerns, such as systemic risk accumulation, have long been recognized by scholars and regulators.[69] Most importantly, clearinghouses traditionally have adequately dealt with these perils. Even the SEC itself acknowledges that the industry is functioning well.[70]

In fact, international policymakers, the drafters of Dodd-Frank, and the EU are betting on the clearinghouse expansion as a panacea of sorts. The way international and national regulators seem to grapple with the clearing-related issues in the wake of the 2008 debacle is

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66 *See* Ivanhoe Partners v. Newmont Mining Corp., No. Civ.A. 9281, 1987 WL 17677, at *1–2 (Del. Ch. Sept. 28, 1987). The case involved the National Securities Clearing Corporation (NSCC).

67 *See, e.g.*, Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29575–76; PRESIDENTIAL TASK FORCE ON MKT. MECHANISMS, BRADY COMMISSION REPORT 51–55, 69 (1988) [hereinafter BRADY COMMISSION REPORT], http://www.archive.org/details/reportofpresiden01unit; U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-90-33, CLEARANCE AND SETTLEMENT REFORM: THE STOCK, OPTIONS, AND FUTURES MARKETS ARE STILL AT RISK 29–38 (1990) [hereinafter GAO, CLEARANCE AND SETTLEMENT REFORM], http://www.gao.gov/assets/150/148885.pdf; Knott & Mills, *supra* note 57, at 163–65.

68 *See, e.g.*, Bernanke, *supra* note 62, at 141–44 (discussing various risks and comparing clearinghouse monitoring and safety nets in light of idiosyncratic and systematic risks); Griffith, *supra* note 12, at 1344–62 (reviewing, generally, regulatory issues, moral hazard, and regulatory and institutional alternatives); Johnson, *supra* note 24, at 225–28; Craig Pirrong, *The Clearinghouse Cure*, REGULATION, Winter 2008–09, at 44, 45–49, http://object.cato.org/sites/cato.org/files/serials/files/regulation/2008/11/v31n4-1.pdf (emphasizing possible moral hazard and adverse selection concerns in clearing of some asset classes); Roe, *supra* note 54, at 1690, 1695 (discussing risk monitoring and transparency concerns).

69 It was acknowledged already in the 1980s that "[t]he integrity and efficiency of the U.S. clearing and settlement systems [are] important to both its internal financial and economic stability and its ability to compete with other nations." OFFICE OF TECH. ASSESSMENT, OTA-CIT-469, ELECTRONIC BULLS AND BEARS: U.S. SECURITIES MARKETS AND INFORMATION TECHNOLOGY 107 (1990), http://www.fas.org/ota/reports/9015.pdf. Alan Greenspan, for example, remarked that his "experience with financial crises has convinced [him] that the greatest threat to the liquidity of our financial markets is the potential for disturbances to the clearance and settlement processes for financial transactions." Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta (Mar. 3, 1995); *see also* Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66263–64 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240); Johnson, *supra* note 24, at 218.

70 Clearing Agency Standards, 77 Fed. Reg. at 66263–64.

twofold. First, international policymakers and Congress have mandated the clearing of some over-the-counter (OTC) derivatives, such as swaps, through centralized clearinghouses.[71] Second, Dodd-Frank has also created "systemically important" financial market utilities (FMUs) and has authorized the Federal Reserve to oversee risk management standards of such institutions, including large C&S entities.[72]

The SEC and the CFTC must now create a common framework for clearing, in consultation with the Fed.[73] Moreover, should the Fed and the SEC differ on certain requirements, and if the Fed believes that such requirements "are insufficient to prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the United States,"[74] the disagreements between the prudential requirements of the Fed and the SEC may ultimately be resolved by an affirmative vote of the Financial Stability Oversight Council.[75] The regulatory turf and authority of the SEC, the CFTC, and the Fed have thus become more closely entwined.

In 2014, the SEC proposed a new clearing rule,[76] building on the first postcrisis regulations promulgated in 2012.[77] As this Article discusses in Part V, the rules alter the regulatory fabric, further moving away from the traditionally cooperative and successful clearinghouse-SEC interaction model, and refocus the regulations on coordination with other agencies and on harmonization.[78] The regulations expose the C&S industry to the hazards of *collectivism* discussed above.

Both of the new regulatory approaches (i.e., the centralized clearing of OTC derivatives and regulatory overcoordination) may be unduly overrated. Scholars, such as Roe[79] and Griffith,[80] have already addressed

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71 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701–774, 124 Stat. 1376, 1641–1803 (2012) (codified as amended in scattered sections of 7 U.S.C. and 15 U.S.C.). For an overview of the regulations, see, for example, Yadav & Turing, *supra* note 10, at 1–2, 16–17.

72 *See, e.g.*, 12 U.S.C. §§ 5464–5465 (2012); Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29512–13.

73 *See, e.g.*, 12 U.S.C. §§ 5464–5468, 5470–5472 (providing for a common framework for designated clearing entity risk management and consultations with the Board of Governors); *see also* RISK MANAGEMENT SUPERVISION OF DESIGNATED CLEARING ENTITIES, *supra* note 8, at 3, 9.

74 12 U.S.C. § 5464(a)(2)(B).

75 *See, e.g.*, *id.* § 5464(a); *see also* RISK MANAGEMENT SUPERVISION OF DESIGNATED CLEARING ENTITIES, *supra* note 8; *Title VIII of the Dodd-Frank Act*, BOARD GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/paymentsystems/title-viii-dfa.htm (last updated Jan. 29, 2015).

76 *See* Standards for Covered Clearing Agencies, 79 Fed. Reg. 29508-01.

77 *See* Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

78 *See* discussion *infra* Part V.

79 Roe, *supra* note 54.

80 Griffith, *supra* note 12.

the potential ramifications of the new derivatives clearing regime. This Article will review the issue from a different vantage point, focusing on the second prong of the reforms: the relationship of the modern overcoordination and potential *collectivism* to sector-specific regulatory arrangements in the traditional, non-OTC-derivatives clearing.

B. *The Four Postulates of an Efficient Market-Regulator Interaction*

In C&S, the interaction between the SEC and clearing agencies before Dodd-Frank was inherently cooperative and principles based. This Section begins with a brief outline of the indispensable postulates of this cooperative model. The analysis in Part III below will provide examples of the application of this successful market-regulator model.

1. Postulate I

The sector-specific regulator should require the industry to promote the standards that more or less closely mirror the preferences of *multiple* stakeholders in the financial industry, including broker-dealers, exchanges, investors, clearinghouses themselves, and others. As discussed further in Part III, the SEC has done just that. Germane examples include requirements such as the fair representation of participants in the management of C&S entities and the establishment of nondiscriminatory clearing standards for all members of the clearinghouses.[81] Most requirements were embedded in generalized principles derived from earlier industry experiments. In a somewhat Hayekian way, the mandatory requirements were sufficiently *general* and principles-based in order to allow room for maneuvering and industry experimentation. Under these conditions, the pre-2008 reforms avoided the crisis-driven overregulation problems[82] and merely motivated the legislature to entrust the regulators with the necessary supervisory authority.

2. Postulate II

The regulator should abstain from frequent and trivial encroachments on the industry's structure and operations. To

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[81] *See, e.g.*, Order, Exchange Act Release No. 20221, 48 Fed. Reg. 45167-02, 45173, 45179 (Sept. 23, 1983); *see also* 15 U.S.C. §§ 78q-1(b)(3)(C),(G),(F) (2012).

[82] *See generally* Romano, *Iron Law of Financial Regulation*, *supra* note 2 (discussing, generally, overregulation concerns).

demonstrate this trend, this Article will review the enforcement actions brought by the SEC against clearinghouses in the past forty years.

3. Postulate III

Market entities must signal to the market and the regulator that they are adequately self-regulated. One way to do that is through participatory corporate governance mechanisms. Clearing agencies operate within a multistakeholder model of corporate governance, fermenting collective decision making through participation of various interest groups, such as broker-dealers, exchanges, self-regulatory organizations, and others.

This, in theory, sends a strong signal to the market. It allows the industry to obviate the Berle and Means dilemmas (i.e., dispersed ownership, control, and oversight issues typically associated with large corporations), or the problems attributed to vertical silos, viz., scenarios when exchanges directly own clearing subsidiaries and may influence or control their decisions to the detriment of the market and clearing participants.[83]

An example of a multistakeholder model is the DTCC, whose board of directors includes representatives of various types of users of the DTCC's services, exchanges such as the New York Stock Exchange (NYSE), and the Financial Industry Regulatory Authority (FINRA), an independent securities regulator.[84]

This participatory structure also must have had a direct effect on the interaction between the regulator and C&S facilities. Based on the positive and reliable signals produced by corporate governance mechanisms, the regulator could rest assured that those who bear the risks of C&S operations (i.e., clearinghouse participants) and FINRA had both incentives *and* an opportunity to closely supervise the entities, ward off potential misbehavior, and demand product and policy improvements.

A positive externality of such multistakeholder corporate signaling is the minimization of the potential risk of monopoly in clearing where a high level of market concentration is often an optimal solution. Namely, the economics of networks and resultant positive network externalities dictate that post-trading services be more consolidated rather than more dispersed.[85] Market entities, in pursuit of economies of

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83 Even though vertical silos are not necessarily inferior to other ownership models, the major enforcement actions discussed in this Article were brought against silos. *See infra* Part IV.

84 *See infra* Section III.C.

85 *See, e.g.*, BAGLIONI & HAMAUI, *supra* note 23, at 8.

scale, often converge into one single player or into a concentrated group of players.[86] A corollary is the need to control for monopoly risks, which in turn partially depends on the reliability of the foregoing corporate governance mechanisms.

The second prong of this Postulate is *potential* competitive pressures. Competition in C&S is not entirely foreclosed. Other entities have an opportunity to join the C&S industry (i.e., the market is *contestable*).[87] It is highly concentrated and all entities are reputable long-term players closely monitored by both the SEC and their own participants. Historically, in this regulated quasi monopoly, the barriers to entry, or, to be more precise, the economic costs associated with the entry as distinguished from the regulatory costs of entry, were high.[88] Yet other entities could still join the market.

An example is the pressure exerted by the Nasdaq's plan to develop a clearing facility rival to that of the DTCC, and the DTCC's resultant response in the form of better service and price terms.[89] This incident exemplifies, inter alia, how dynamic efficiency was achieved within the currently highly concentrated C&S market.

In a sense, natural market selection has created a highly concentrated industry model. Even though perfect competition is usually a first-best outcome, strong economies of scale in C&S dictated a different industry structure.[90] Using the formula of Alchian, built upon by Manne and Zywicki, the clearing market is still subject to *potential* "evolutionary market pressures," undermining "sustained monopoly power."[91]

In summary, from a purely statutory and economic perspective, the SEC-regulated clearinghouses operate in an imperfectly contestable monopoly environment,[92] are monitored by a variety of constituencies through a participatory corporate governance model, and ultimately,

86 *See, e.g.*, Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29587–90 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240); Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66265 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

87 *See, e.g.*, van Cayseele & voor de Mededinging, *supra* note 21, at 14–15 (discussing the contestable market theory, related studies, and their application in C&S); Serifsoy & Weiß, *supra* note 21, at 24–29 (reviewing market contestability in application to securities markets).

88 *See* Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29576, 29578; *infra* Section III.C.

89 *See infra* note 205 and accompanying text.

90 *See, e.g.*, van Cayseele & voor de Mededinging, *supra* note 21, at 4–6 (observing also that "[t]he trade-off . . . is between competitive prices with a fragmented industry structure that does not succeed in fully exploiting scale and scope economies, versus a concentrated industry structure with the possibility of monopoly pricing").

91 Manne & Zywicki, *supra* note 19, at 18.

92 In reality, as illustrated *infra* Section III.C, smaller facilities have been steadily exiting the industry. The true competitors are yet to materialize.

charge the trading community lower C&S costs compared to those in other jurisdictions.[93] The model scores high in terms of the dynamic efficiency, economies of scale and scope, network effects, and systemic efficiency.

4. Postulate IV

If a centralized regulator and market entities abide by Postulates I, II, and III, courts should be deferential to their policy choices. A review of the forty years of case law involving clearinghouses confirms this observation. U.S. courts repeatedly and predictably supported the monopolistic regulator *and* the clearing agencies whose rules the regulator approves.[94]

The key exception was private, opportunistic actions of clearinghouses. As demonstrated in Section IV.B, courts bifurcate clearinghouse actions into (a) private actions, which can be motivated by opportunism and self-interest, and (b) preapproved public functions, where the potentially opportunistic behavior at issue is either controlled by the regulator or captured by the internal corporate mechanisms discussed above.

This dichotomy stems from the dual nature of C&S facilities. On the one hand, they operate in a semipublic capacity, as SROs assuring stable and low-cost trade execution in the national markets. On the other hand, they function as private entities and may interact with the outside world as such. This is *outside* of their core public functions.

Their private negotiations and contracts may equally be outside the ambit of the SEC-approved programs. Similarly, the foregoing internal corporate governance mechanisms (i.e., Postulate III) may not capture such misbehavior since they are designed mainly for monitoring the safety of the public functions. Monitoring market participants-shareholders may be more interested in overseeing the public functions, the risks of which they collectively share.

Just like any other private company, a clearinghouse may be motivated by opportunism. Hence, it is logical that courts scrutinize the clearinghouses' private decisions and ordinary contracts more closely, while deferring to the SEC and clearinghouses in other matters.[95]

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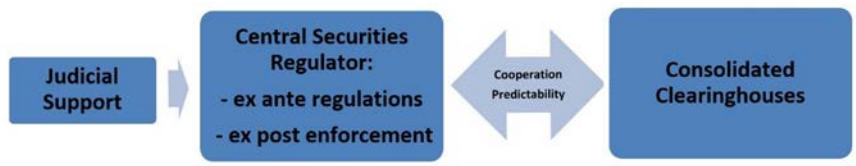
93 *See supra* notes 21–24 and accompanying text.

94 *See* discussion *infra* Section IV.B.2.

95 A word of caution is in order. It would be a logical fallacy to present these results as normative implications of the exiting model. Part IV of this Article merely emphasizes the positive premises of the current arrangement. However, the cumulative impact of the majority of the sample cases may be suggestive of deeper, more normative implications.

Pictorially, the Postulates may be presented as follows:



This approach entails a predictable regulatory framework for transactional exchanges. The benefits of *linear* regulatory interaction and market concentration also should outweigh monopoly costs in an equilibrium involving one sector-specific regulator, a concentrated industry, and one set of courts.

In equilibrium, the market's and the regulator's "foresight" of the *intent* of clearinghouses to perform is improved. The relationships are stable and "based on the expectation of the same set of external facts, so that under certain conditions nobody [including the regulators, clearinghouses, and market participants] will have any reason to change his plans."[96]

The facility, closely monitored by its shareholders and members, cannot switch to a socially harmful suboptimal strategy without public and private parties or *potential* market competitors observing the problem and changing their strategies accordingly. In turn, courts, protecting the rights of an allegedly aggrieved private litigant, have nothing to gain from not deferring to the regulator and the facility-SRO, perhaps, in fear of inadvertently upsetting the economic and regulatory balance.[97] Finally, the regulator continues its policies of arm's length monitoring and principles-based rulemaking.

In this sense, such decision makers as the SEC and the courts effectively adopted the Hayekian view, acting within the preexisting boundaries of regulatory and market norms and allowing individuals (i.e., the clearing industry) to "have maximum freedom to act on local information as it arises."[98]

That *linear* sector-specific model has proven cost efficient and well-functioning through the vicissitudes of market crises over the course of several decades. Unfortunately, it is inherently at odds with

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96 F. A. von Hayek, *Economics and Knowledge*, ECONOMICA, Feb. 1937, at 33, 41.

97 *See infra* Section IV.B.1.

98 Todd J. Zywicki & Anthony B. Sanders, *Posner, Hayek, and the Economic Analysis of Law*, 93 IOWA L. REV. 559, 578 (2008).

the coordinating posture of the post–Dodd-Frank reforms. In the following Sections, I will first support the postulates with case studies and will then conclude with a discussion of the specific Dodd-Frank rules.

III. Postulates I and III: Ex Ante Regulatory Premises and Market Signaling

A. *Introduction*

This Part examines Postulates I and III. The analysis will demonstrate several trends, which were typical of the period between 1975 and 2010 (i.e., covering the 1975 Exchange Act amendments and the subsequent major regulations preceding Dodd-Frank). The reforms created a sector-specific regulatory monopoly and were crisis driven. Nevertheless, they proved to improve efficiency in terms of reducing transaction costs in C&S. The possible reasons are as follows.

At an abstract level, the regulatory initiatives followed a familiar pattern—when ex ante industry programs were insufficient to prevent a market wide disruption or inefficiencies, regulatory reforms ensued. In contrast to the reforms of today, however, the regulators de facto expedited the processes that the market itself had already demanded of the clearing industry. The regulations tracked earlier industry experiments, converted the prior private practices into generalized standards, and thus followed the impetus supplied by the market.[99]

In theory, such a fluid arrangement required preserving a modicum of discretion for *both* the market and the regulators. Both must have sufficient flexibility to act and cooperatively shape the best practices. This Section will demonstrate that the SEC indeed pursued a generalized principles-based approach to the first clearinghouse rules and registration, as captured by Postulate I.[100]

In turn, clearinghouses sent adequate signals to the market regarding their self-regulatory capacity. A unique corporate governance structure inviting direct participation of the clearing members, who by virtue of their financial exposure shared clearing risks (i.e., Postulate III), served as an internal verification mechanism. Consequently, the

99 Henry F. Minnerop, *Clearing Arrangements*, 58 BUS. LAW. 917, 958 (2003) (emphasizing the economic benefits of regulatory actions in the C&S market).

100 Indeed, the statutory reforms did not "require the SEC to examine every registration application in light of the broader national goals in section 17A(a), [and] they only require[d] the application to meet the requirements for registration set forth in section 17A(b)." Bradford Nat'l Clearing Corp. v. Sec. & Exch. Comm'n, 590 F.2d 1085, 1093 n.5 (D.C. Cir. 1978) (citations omitted).

risk-incentive structures, monitoring objectives, and self-regulatory mechanisms were optimized. This Part will also examine these mechanisms in light of the monopoly concerns and market concentration.

B. *Postulate I: Market-Regulator Cooperation*

1. The Back Office Crisis and Postcrisis Reforms

a. Market Realities

The first regulations were promulgated in response to a crisis and to underlying structural market inefficiencies.[101] At first, clearing was fragmented as stock exchanges operated their own clearinghouses.[102] Brokers cleared trades through a clearing subsidiary affiliated with the market on which execution occurred.[103] This structure and the facilities quickly became outdated.[104] A more interconnected, efficient, and automated system of C&S was objectively needed in order to cope with rapid changes in trading practices.

For example, the volume and size of institutional trades increased dramatically.[105] "The velocity and volume of . . . trading [by large institutions] strained an exchange market accustomed to a continuous flow of relatively homogenous transactions."[106] Simultaneously, the army of individual shareholders grew almost threefold.[107] As a result, the processing facilities of exchanges had to evolve rapidly.

The parallel growth of the OTC market hindered the operations of transfer agents[108] and clearing operations in general. As a matter of practice, broker-dealers cleared and settled trades directly with their

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101 I have already discussed these trends in my earlier work. *See* Guseva, *supra* note 53, at 548–49. In this Article, the analysis addresses them from a different perspective—linearity and market-regulator cooperation.

102 *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 316.

103 *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1096 n.13.

104 *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 317–18.

105 *See, e.g.*, S. REP. NO. 93-13, at 65–66 (1973); Rita Ann Coyne, Comment, *International Securities Trading: The United States and Great Britain Develop Clearing and Settlement Procedures for a New Age*, 19 CAL. W. INT'L L.J. 129, 132–35 (1988) (describing the history of the U.S. C&S system); Walter Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233, 1256 (1975).

106 Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 767 (1984).

107 SEC. & EXCH. COMM'N, SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 1, at 15, 21 (1963).

108 *See, e.g.*, SEC. & EXCH. COMM'N, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 92-231, at 13–14 (1971); Michael J. Simon & Robert L. D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 19–21 (1986).

counterparties, which led to "frequent disagreement over the terms of a trade on settlement [resulting] from the practice of executing trades over the telephone"[109] and physical delivery of trade documents.[110]

Slowly, "[d]eliveries and transfers of securities became inexorably mired."[111] Ballooning overhead expenses of brokerages[112] and the growth of "fails to deliver" and "fails to receive"[113] against a heavy trading volume[114] precipitated the back office crisis and liquidation of some brokerages.[115] In part, the mayhem was an example of the negative externalities produced by uncoordinated brokerages' policies and underinvestment in back office operations. Unable to fully and immediately internalize the benefits and costs of improved back office operations, individual brokerages overinvested in sales, ignoring their own clearing and processing facilities.[116]

Even though trading venues were not oblivious to the problems, their programs were incremental. For example, some exchanges and the National Association of Securities Dealers (NASD) improved their technology and operations,[117] helped brokerages immobilize stock certificates, and introduced more advanced holding systems.[118] By the

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109 Simon & Colby, *supra* note 108, at 89.

110 DEPOSITORY TR. & CLEARING CORP., THE US MODEL FOR CLEARING AND SETTLEMENT: AN OVERVIEW OF DTCC 12 (2007) [hereinafter DTCC, THE US MODEL FOR CLEARING AND SETTLEMENT]; Larry E. Bergmann, Senior Assoc. Dir., Div. of Mkt. Regulation, U.S. Sec. & Exch. Comm'n, Speech at the International Securities Settlement Conference: The U.S. View of the Role of Regulation in Market Efficiency (Feb. 10, 2004), http://www.sec.gov/news/speech/spch021004leb.htm.

111 H.R. DOC. NO. 92-231, at 19.

112 S. REP. NO. 93-13, at 29 (1973).

113 *See, e.g.*, Egon Guttman, *Transfer of Securities: State and Federal Interaction*, 12 CARDOZO L. REV. 437, 446, 447 & n.61 (1990) (quoting *Clearing and Settlement of Securities Transactions: Hearings on S. 3212, S. 3297 and S. 2551 Before the S. Subcomm. on Sec. of the S. Comm. on Banking, Hous. & Urban Affairs*, 92d Cong. 95–96 (1972) (statement of William J. Carey, Chairman, U.S. Securities and Exchange Commission)).

114 H.R. DOC. NO. 92-231, at 18.

115 *See, e.g.*, Order Granting Registration and Statement of Reasons, 42 Fed. Reg. 3916-01, 3918 (Sec. & Exch. Comm'n Jan. 21, 1977); H.R. DOC. NO. 92-231, at 13–14, 36; Wolkoff & Werner, *supra* note 15, at 317–18.

116 *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 320.

117 For instance, the NYSE and several custodian banks launched a one-year "Pilot Operation for Central Handling of Securities," through which some "deliveries were made between members via book-entry and without the physical movement of certificates." DTCC, THE US MODEL FOR CLEARING AND SETTLEMENT, *supra* note 110, at 12. Already in the early 1960s, the NASD created the National OTC Clearing Corporation, although direct deliveries continued. Simon & Colby, *supra* note 108, at 73 & n.349, 74, 89.

118 *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 323 (discussing depository initiatives); *see also* S. REP. NO. 93-13, at 28 (1973) (also discussing processing and equipment problems of brokerages); Bergmann, *supra* note 110. The NYSE introduced more advanced holding systems in 1968. The NYSE improved C&S and developed the Central Certificate Service, which "act[ed] as a clearinghouse for transactions involving stocks held in 'Street name.'" *Wall Street: Attack on the Snarl*, TIME, May 24, 1968, http://www.time.com/time/magazine/article/0,9171,844480,00.html. Unfortunately, operational problems remained and many new order

early 1970s, the American Stock Exchange (AMEX) and the NYSE owned the Securities Industry Automation Corporation,[119] operating their clearinghouses and clearing transactions in AMEX-listed and NYSE-listed securities, respectively.[120] In 1969, the NASD also created a new CCP-type subsidiary,[121] and soon entered into a management contract with Bradford National Corporation.[122]

However, brokers were still incurring unnecessary operational expenses by reconciling trades through separate facilities.[123] In fact, many clearing entities did not "provide [their] participants with the ability to compare through the clearing corporation transactions other than those effected in the marketplaces for which the clearing corporation perform[ed] the comparison function."[124]

b. Postulate I: In the Footsteps of the Market

Congress responded not only to the crisis per se, but also to the demands expressed by market participants, and to the need for a safer and more interlinked C&S system. In 1975, the Exchange Act was amended and the SEC finally received statutory oversight authority over clearing agencies and transfer agents.[125]

Unless exempted by the SEC, all clearinghouses operating in the securities market were (and still are) required to register with the SEC.[126] Some clearinghouses are required to register with both the SEC and the CFTC if they also fall under the statutory definition of "derivatives clearing organizations" and clear transactions in securities and derivatives.[127] The law also demarcated the regulatory jurisdiction of the SEC and other "appropriate regulatory agencies," such as the

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execution, delivery, and certificate handling programs and electronic data processing were not entirely successful. Simon & Colby, *supra* note 108, at 89; Werner, *supra* note 105, at 1257; Werner, *supra* note 106, at 767–68.

119 Nat'l Sec. Clearing Corp., 42 Fed. Reg. at 3923–27.

120 *Id.* at 3929; *see also* Donald L. Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 VA. L. REV. 785, 808 (1984) (detailing the progress made by the NYSE); Simon & Colby, *supra* note 108, at 89.

121 The NASD created the National Clearing Corporation. *See* Nat'l Sec. Clearing Corp., 42 Fed. Reg. at 3923–27.

122 Wolkoff & Werner, *supra* note 15, at 321.

123 Nat'l Sec. Clearing Corp., 42 Fed. Reg. at 3922–23, 3930.

124 *Id.* at 3930. In addition, having three New York-based clearinghouses was redundant. Bradford Nat'l Clearing Corp. v. Sec. & Exch. Comm'n, 590 F.2d 1085, 1097, 1098 & n.21 (D.C. Cir. 1978).

125 The National System for Clearance and Settlement of Securities Transactions was added to the Securities Exchange Act of 1934. Act of June 4, 1975, Pub. L. No. 94-29, § 15, 89 Stat. 97, 141 (codified as amended at 15 U.S.C. § 78q-1 (2012)).

126 *See, e.g.*, 15 U.S.C. § 78q-1(b)(1); 15 U.S.C. § 78s(a)(2); 17 C.F.R. § 240.17Ab2-1 (2015).

127 7 U.S.C. § 7a-1(a) (2012). A traditional example of such a clearinghouse is the Options Clearing Corporation (OCC).

Fed,[128] giving the SEC the primary oversight and rulemaking authority over securities clearing.

As the primary securities market regulator, the Commission was directed to establish uniform procedures for C&S and facilitate development of a national C&S system.[129] In this respect, the SEC apparently proceeded in agreement with what the major trading venues attempted to achieve, as all New York-based heavyweights availed themselves of the new opportunities. They filed a joint application for registration of a single clearinghouse, the National Securities Clearing Corporation (NSCC).[130] By that time, their facilities already had been responsible for the majority of clearing operations, while the share of regional exchanges comprised about fifteen percent.[131] The leaders, facing only some antimonopoly opposition from SEC Chairman Ray Garrett,[132] pursued deeper market concentration.[133]

The proposed entity "was conceived as the central element in an integrated nationwide effort to eliminate unnecessary duplication of post-trade activities and to permit single-account clearing and settlement for broker-dealers in the clearing organization of their choice."[134] The new Depository Trust Company (DTC) was to serve as a single securities depository for the NSCC. The applicants and the Commission clearly expected that one locus for comparison and settlement of transactions executed on the major exchanges and OTC markets would produce economies of scale and operational savings.[135]

On the flipside, however, joining the forces of the NYSE, the AMEX, and the NASD might stifle market competition.[136] Thus, the SEC was effectively required to make a first economic judgment call on clearing. The Commission seemed to have approached this task

128 15 U.S.C. § 78c(a)(34).

129 *Id.* § 78q-1(a)(2)(A); *see also Bradford Nat'l Clearing Corp.*, 590 F.2d at 1100–01.

130 *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1097–98, 1113; *see also* Wolkoff & Werner, *supra* note 15, at 326.

131 *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1096 n.13.

132 Wolkoff & Werner, *supra* note 15, at 320–22 (suggesting that the SEC was supportive of centralization).

133 For instance, drawing on the initiative of the Securities Industry Association, the NASD, and the NYSE, the National Securities Processing Committee was organized with the explicit objective of developing a national clearing facility. *See, e.g.*, Nat'l Sec. Clearing Corp., Exchange Act Release No. 13163, 1977 WL 173551, at *13 (Jan. 13, 1977) (order); Single National Clearing and Settlement Organization, 39 Fed. Reg. 9884-02, 9884 (Sec. & Exch. Comm'n Mar. 14, 1974) (notice); Eli Weinberg et al., *Development of a National System for Clearing and Settling Securities Transactions*, *in* 2 EXPLORATIONS IN ECONOMIC RESEARCH: REGIONAL STOCK EXCHANGES IN A CENTRAL MARKET SYSTEM 353, 353–77 (Nat'l Bureau of Econ. Research ed., 1975).

134 Calvin, *supra* note 120, at 800.

135 Order Granting Registration and Statement of Reasons, 42 Fed. Reg. 3916-01, 3925–26 (Sec. & Exch. Comm'n Jan. 21, 1977).

136 *Id.*; *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1100–01, 1107.

carefully, tracking the demands of the market. It observed, inter alia, that "[t]he importance of NSCC's establishment to [the] progress [in clearing] and the significance of the accords and compromises on which NSCC's establishment is based can be gauged only against the backdrop of a decade of industry effort."[137]

The antitrust arguments did not sway the SEC or its promerger policy stance, as it sided with the naturally merging large applicants over objections of smaller clearinghouses.[138] At the same time, however, the Commission refused to foreclose the competition entirely. Instead, it facilitated the contestable monopoly environment and focused on competition in trading and on restrictions on vertical silos.[139]

It is plausible that the SEC de facto endorsed the trend towards consolidation, bypassing antitrust objections and effectively channeling the market towards a monopoly equilibrium, to ensure a more robust *national* clearing infrastructure.[140] Furthermore, in implementing the National Market System and clearing reforms, "the SEC took its cues from the legislation . . . and worked with the industry to create a climate of intraindustry cooperation."[141] Cumulatively, this approach was in line with Postulate I.

Another example in support of Postulate I is granting the C&S facilities the status of SROs.[142] Congress, obviously, took a leaf from the exchange regulation book. Clearing agencies, for instance, were required

137 Nat'l Sec. Clearing Corp., 1977 WL 173551, at *12 ("The Commission's review of NSCC's application has been made in the context of the progress in clearing and settlement achieved during the last decade and the efforts of entities engaged in securities processing—brokers and dealers, clearing corporations, securities depositories, transfer agents, institutional investors, securities exchanges and the [NASD]—to establish clearing and settlement systems and to integrate them into a national system.").

138 *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1106–13. Analogous processes of market concentration also occurred in the depository business. Already by the 1980s, DTC was a major depository. *See infra* Section III.C.

139 Wolkoff & Werner, *supra* note 15, 328–32, 370 (discussing the rule changes and their effect on competition, as well as how the SEC disentangled clearing and trading). Under certain conditions, an oligopoly may be a more efficient outcome, and excessive regulations of such a market-driven structure become unnecessary from the welfare economics perspective. *See, e.g.*, van Cayseele & voor de Mededinging, *supra* note 21, at 12-14.

140 The improvements entailing a monopoly approval could have been incremental. As the court in *Bradford* observed, the SEC's "decision passes statutory muster so long as the former achievements by whatever margin outweigh the latter impacts." *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1107. On the central role of regulators in shaping competition and monopoly equilibria in post-trading services, see, for example, BAGLIONI & HAMAUI, *supra* note 23, at 9–11, 15.

141 Calvin, *supra* note 120, at 795. Even the critics of the SEC at the time mentioned that "Congress and the regulatory agency had . . . done their homework well." Werner, *supra* note 105, at 1234 (focusing primarily on NMS). Generally, however, Professor Werner was critical of the SEC and the implementation of the statutory mandate. *Id.* at 1296.

142 *See* 15 U.S.C. § 78c(a)(26) (2012).

to report any proposed rule changes to the SEC.[143] As SROs, the agencies also were enabled and required, inter alia, to monitor their participants, exercise disciplinary authority over the participants, and deny participation to disqualified or incompetent applicants.[144] Variations among agencies could persist, but the generalized principles were uniform for all.

On the one hand, this authority assisted the agencies in risk assessment and detecting "bad apples," which is a crucial avowed benefit of a centralized and transparent clearing infrastructure. On the other hand, to prevent abuse by individual agencies, the integrity of such rules was ensured through structural transparency, antidiscrimination, and due process requirements. Those spanned equal access and similar requirements for *all* participants, fair representation of members in management,[145] and impartial hearings and disciplinary policies.[146] Logically, both the trading community and the clearinghouses should be supportive of such regulatory standards.

Another crucial argument supporting the historical trends embedded in Postulate I is that, following in the footsteps of the earlier industry initiatives, the SEC was directed to facilitate certain market trends. The first was the immobilization of securities in order to "end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities consummated by means of the mails."[147] Recall that exchanges and custodian banks had tried to reduce physical deliveries around the time of the paperwork crisis. After the first reforms, decades of concerted market-regulator efforts ensued.[148]

In a similar vein, the SEC also supported certain securities holding practices. Among others, it was in favor of holding securities in "street

143 *Id.* § 78s(b).

144 *Id.* § 78q-1(b).

145 *Id.*

146 *Id.* §§ 78q-1(b)(3), (b)(5); Order, Exchange Act Release No. 20221, 48 Fed. Reg. 45167-02 (Sept. 23, 1983).

147 15 U.S.C. § 78q-1(e).

148 *See, e.g.*, Order Approving Proposed Rule Change Instituting Same-Day Funds Settlement Service, Exchange Act Release No. 24689, 52 Fed. Reg. 26613-01, 26616 & nn.20–21 (July 15, 1987) (discussing the progress and citing the DIV. OF MKT. REGULATION, SEC. & EXCH. COMM'N, PROGRESS AND PROSPECTS: DEPOSITORY IMMOBILIZATION OF SECURITIES AND USE OF BOOK-ENTRY SYSTEMS (1985)); Securities Transactions Settlement, Securities Act Release No. 8398, Exchange Act Release No. 49405, Investment Company Act Release No. 26384, 69 Fed. Reg. 12922-01 (proposed Mar. 18, 2004); Transfer Agents Operating Direct Registration System, Exchange Act Release No. 35038, 1994 WL 681687 (Dec. 1, 1994) (concept release); Ralph C. Ferrara & Konrad S. Alt, *Immobilization of the Security Certificate: The U.S. Experience*, 15 SEC. REG. L.J. 228, 235–42 (1987).

name," a "major step towards having in effect a certificateless system,"[149] replacing the practice of holding physical securities certificates with indirect holding systems through centralized depositories,[150] and the more recent direct registration system (DRS), which ultimately allowed individual investors to establish direct positions with an issuer.[151] In this supportive regulator-market environment, the industry was able to reduce the formerly enormous costs and risks associated with handling security certificates[152] and to immobilize most listed equity securities.[153]

Concomitant antitrust concerns were, again, not prominent on the list of objections. For instance, since the DTC operated the sole functional DRS program, issuers and exchanges had no choice but to subscribe to that service. The major exchanges and the SEC nevertheless welcomed these clearing innovations.[154] Even though—as DRS and

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149 4 JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 28:13 (3d ed. 2015); *see also* ALAN L. BELLER & JANET L. FISHER, THE OBO/NOBO DISTINCTION IN BENEFICIAL OWNERSHIP: IMPLICATIONS FOR SHAREOWNER COMMUNICATIONS AND VOTING 8–10 (2010), http://www.sec.gov/comments/s7-14-10/s71410-22.pdf; SEC. & EXCH. COMM'N, THE PRACTICE OF RECORDING THE OWNERSHIP OF SECURITIES IN THE RECORDS OF THE ISSUER IN OTHER THAN THE NAME OF THE BENEFICIAL OWNER OF SUCH SECURITIES (1976), https://archive.org/stream/fsec00unit#page/n0/mode/2up.

150 *See, e.g.*, COX & HAZEN, *supra* note 149; James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article* 8, 43 UCLA L. REV. 1431, 1442–44 (1996). Importantly, depositories cooperated to achieve these results and to coordinate their programs. *See, e.g.*, Order Approving Proposed Rule Changes, 47 Fed. Reg. 51658-02, 51659–60 (U.S. Sec. & Exch. Comm'n Nov. 9, 1982) (describing a cooperative effort); *see also* JERRY W. MARKHAM & THOMAS LEE HAZEN, 23A BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 13:5 (perm. ed., rev. vol. 2015).

151 It became another "important step in reducing the use of physical certificates which . . . facilitate[d] efficiencies and reduce[d] risks in securities transactions and . . . eventually [led] to lower costs for issuers and investors." Notice of Filing of Proposed Rule Change by NASDAQ to Require Securities Be Eligible for a Direct Registration System, Exchange Act Release No. 53913, 71 Fed. Reg. 33024-01, 33024 (May 31, 2006); *see also* Order Granting Approval of a Proposed Rule Change Amending Rules to Mandate Listed Companies Become Eligible to Participate in a Direct Registration System, Exchange Act Release No. 54410, 71 Fed. Reg. 54316-01, 54317 (Sept. 7, 2006).

152 For a historical description and cost data, see, for example, Securities Transactions Settlement, 69 Fed. Reg. at 12934 & n.134.

153 Already ten years ago, more than eighty-five percent of the equity securities listed on the NYSE and eighty percent on Nasdaq and the AMEX were immobilized. *See* Letter from Jill M. Considine, Chairman & Chief Exec. Officer, Depository Tr. & Clearing Corp., to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n 9 (June 23, 2004), http://www.sec.gov/rules/concept/s71304/s71304-26.pdf.

154 NYSE Arca, Inc., 71 Fed. Reg. at 54317; *see also* Order Granting Approval of a Proposed Rule Change Related to the Direct Registration Program, Exchange Act Release No. 58125, 2008 WL 2986526 (July 9, 2008); Order Granting Accelerated Approval of Proposed Rule Changes to Extend the Deadline for Issuers to Become Compliant with Listing Requirements Concerning Direct Registration Programs, Exchange Act Release No. 57062, 73 Fed. Reg. 900-01 (Dec. 28, 2007); Order Granting Approval of a Proposed Rule Change Requiring Securities Be Eligible to Participate in a Direct Registration System, Exchange Act Release No. 54288, 71 Fed. Reg. 47276-01 (Aug. 8, 2006); Order Granting Approval of a Proposed Rule Change Amending the Listed Company Manual to Mandate Listed Companies to Become Eligible to

other DTC's programs were evolving[155]—some transfer agents accused the DTC of abusing its monopoly,[156] such claims did not alter the general picture—so long as the de facto monopolistic programs were generating tangible benefits, antitrust concerns seemed subordinate.

Another example of a cautious and circumspect SEC is the introduction of a more uniform settlement cycle,[157] and clarification of settlement timing and finality, which only occurred following *clearly expressed* market concerns and consensus.[158] The temporal connection between time and risk is clear: Parties may become insolvent and fail to pay for or deliver securities when prices change.[159] In the worst-case scenario, a "systemic disturbance to financial markets and to the economy" may follow.[160] The SEC's decision to reduce the settlement cycle to three days (T+3)[161] and the accompanying industry efforts entailed a reduction in fails to deliver, demonstrating the efficaciousness of that regulation.[162]

Participate in a Direct Registration System, Exchange Act Release No. 54289, 71 Fed. Reg. 47278-01 (Aug. 8, 2006); Order Approving a Proposed Rule Change Regarding the Transfer of Securities of Issuers Listed on the Nasdaq Stock Market that Are Held Pursuant to a Direct Registration Program, Exchange Act Release No. 39369, 62 Fed. Reg. 64034-01 (Nov. 26, 1997); Order Granting Accelerated Approval of Proposed Rule Change Relating to Stock Distributions, Exchange Act Release No. 37937, 61 Fed. Reg. 58728-01 (Nov. 8, 1996); Securities Transactions Settlement, 69 Fed. Reg. 12922-01.

155 *See, e.g.*, Order Granting Approval of a Proposed Rule Change as Amended Relating to FAST and DRS Limited Participant Requirements for Transfer Agents, Exchange Act Release No. 60196, 74 Fed. Reg. 33496-01, 33497–98, 33500 (June 30, 2009); Notice of Filing of Proposed Rule Change Relating to the Requirement to Maintain a Balance Certificate in the Fast Automated Securities Transfer Program, Exchange Act Release No. 63320, 75 Fed. Reg. 71473-04 (Nov. 16, 2010).

156 *See, e.g.*, Letter from Steven Nelson, Chairman & President, Cont'l Stock Transfer & Tr. Co., to Nancy M. Morris, Sec'y, U.S. Sec. & Exch. Comm'n (June 20, 2007), http://www.sec.gov/comments/sr-dtc-2006-16/dtc200616-12.pdf.

157 *See* 17 C.F.R. § 240.15c6-1 (2015). For a description of the Rule, see, for example, HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 10A INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 26:93 (perm. ed., rev. vol. 2016).

158 *See* Rogers, *supra* note 150, at 1446–73 (providing a general overview); *see also* Guttman, *supra* note 113 (discussing Article 8 of the UCC).

159 *See generally* Report of the Bachmann Task Force on Clearance and Settlement Reform in U.S. Securities Markets, Exchange Act Release No. 30802, 1992 WL 150782 (June 15, 1992) (to be codified at 17 C.F.R. pt. 240) (submitting the Bachmann Task Force report to the chairman of the SEC); Rogers, *supra* note 150, at 1437–41.

160 Securities Transactions Settlement, Securities Act Release No. 8398, Exchange Act Release No. 49405, Investment Company Act Release No. 26384, 69 Fed. Reg. 12922-01, 12926 (proposed Mar. 18, 2004).

161 17 C.F.R. § 240.15c6-1 (2015); *see also* BLOOMENTHAL & WOLFF, *supra* note 157; Securities Transactions Settlement, Securities Act Release No. 7022, Exchange Act Release No. 33023, Investment Company Act Release No. 19768, 1993 WL 403275 (Oct. 6, 1993) (to be codified at 17 C.F.R. pts. 200 and 240); Report of the Bachmann Task Force, 1992 WL 150782.

162 Securities Transactions Settlement, 69 Fed. Reg. at 12926 n.49. The new standards were accompanied by a plethora of DTC initiatives. *See, e.g.*, Confirmation and Affirmation of Securities Trades; Matching, Exchange Act Release No. 39829, 1998 WL 156553 (Apr. 6, 1998)

By contrast, when the SEC revisited the same issue a decade later, market actors were demonstrably uncertain whether the benefits of a shorter cycle would outweigh the costs of implementation.[163] The SEC did not choose sides in the face of uncertainty, but allowed the industry to move naturally to operational improvements, straight-through processing, and other programs,[164] until modern technology prompted clearinghouses to reopen the debate.[165]

As a sidebar, the SEC did not act alone; the topic was communicated to the President's Working Group, a precrisis interagency coordination mechanism.[166] To summarize, this short analysis lays out a remarkable policy algorithm—the functional, sector-specific regulator operated within the impetus-reform, market-regulator framework, mimicking the industry initiatives.

2. Another Crash and Another Crisis-Driven Regulatory Response

This short discussion of Postulate I depicts a different SEC—a Commission following the industry's lead. It is, of course, possible that

(to be codified at 17 C.F.R. pt. 241); Order Approving Proposed Rule Changes to Provide for the Settlement of Institutional Transactions Through ID Net, Exchange Act Release No. 57901, 73 Fed. Reg. 32373-01 (June 2, 2008); DEPOSITORY TR. & CLEARING CORP., ID NET: INSTITUTIONAL DELIVERY NETTING SERVICE (2009), http://www.dtcc.com/~/media/Files/Downloads/Clearing-Services/IDNet.pdf.

163 The uncertainty concerned conflicting industry findings: some studies advocated shortening the settlement cycle as a means of reducing settlement exposure by as much as $250 billion, or sixty-seven percent, while other reports highlighted potential offsetting costs related to cross-border market activity and technical upgrades. Securities Transactions Settlement, 69 Fed. Reg. at 12929–30.

164 The industry-wide "straight-through processing," including automation of trade execution and other operational advances, such as "delivery versus payment" and better trade matching, were the new market initiatives approved by the Commission. *See, e.g.*, *id.* at 12923–25; COMM. ON PAYMENT & SETTLEMENT SYS., BANK FOR INT'L SETTLEMENTS, DELIVERY VERSUS PAYMENT IN SECURITIES SETTLEMENT SYSTEMS 4 (1992), http://www.bis.org/cpmi/publ/d06.pdf; CPSS-IOSCO, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES, *supra* note 12, at 8, 22, 40, 141–56 (discussing DVP, receive versus payment (RVP), and other settlement risk reduction models); DEPOSITORY TR. CO., RULES, BY-LAWS AND ORGANIZATION CERTIFICATE, *supra* note 59, at 51–52 (discussing delivery versus payment (DVP) settlement).

165 DEPOSITORY TR. & CLEARING CORP., DTCC RECOMMENDS SHORTENING THE U.S. TRADE SETTLEMENT CYCLE (2014), http://www.dtcc.com/~/media/Files/Downloads/WhitePapers/T2-Shortened-Cycle-WP.pdf; PRICEWATERHOUSECOOPERS LLP, SHORTENING THE SETTLEMENT CYCLE: THE MOVE TO T+2 (2015), http://www.ust2.com/pdfs/ssc.pdf?n=83191.

166 GAO, FINANCIAL REGULATORY COORDINATION, *supra* note 50; *see also* Cunningham & Zaring, *supra* note 1, at 77–79 (discussing the added value of the Group and observing that "[d]uring the 2008 crisis, according to Volcker's Group of Thirty Report, the PWG 'provided the backdrop for U.S. financial supervisors to respond quickly and decisively' by fostering 'ongoing and fluid communication among regulators'" (quoting GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE 49 (2008))).

since the C&S industry exhibited superlative cost efficiency, the SEC could reasonably "afford" to abstain from excessive interventions. Yet this hands-off approach proved durable and survived through market crashes when the C&S system—although without any direct failures—was in peril.

One germane example is the 1987 crash. The crash has been well studied in the literature. It suffices, therefore, to mention such problems as the increasing interconnectivity of financial markets, portfolio-insurance-triggered sales, serious liquidity concerns, and failures of some brokers and futures commission merchants to make payments to clearing organizations.[167] Just like with the recent bailouts of financial institutions, although at an incomparably smaller scale, the Fed had to intervene by supporting liquidity.[168] Overall, even though clearing entities interrupted services and liquidated positions of a few brokers,[169] the national C&S system withstood the 1987 crash.[170]

As mentioned in the Introduction, clearing agencies demonstrated similar resilience in 2008. Indeed, some of the problems are recurrent—as collateral deteriorates, counterparties, clearinghouses, and lenders may demand more collateral, causing financially distressed borrowers to sell at already low prices. To some extent, that happened in 1987, and on a larger scale more recently in 2008.[171]

In addition, the interconnectivity of clearinghouses, and financial markets in general, has its downsides, including more complicated

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167 *See, e.g.*, Securities Transactions Settlement, Securities Act Release No. 7022, Exchange Act Release No. 33023, Investment Company Act Release No. 19768, 1993 WL 403275, at *3 (Oct. 6, 1993) (to be codified at 17 C.F.R. pts. 200 and 240), ("During and after the week of October 19, 1987, over 50 introducing brokers failed, many as a result of the inability of customers to meet margin calls and pay settlement obligations."); GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 18–33; Bernanke, *supra* note 62, at 146–48; Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993, 2011–31 (1988).

168 BRADY COMMISSION REPORT, *supra* note 67, at 51–52; Bernanke, *supra* note 62, at 134, 148; Mark Carlson, *A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response* (Fed. Reserve Bd., Working Paper No. 2007-13, 2006), www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf. On similar structural concerns, see, for example, Cunningham & Zaring, *supra* note 1, at 52–53; Whitehead, *supra* note 12, at 356–57 (discussing the effect of portfolio insurance).

169 Order Approving Proposed Rule Changes, Exchange Act Release No. 27044, 1989 WL 550672, at *6 (July 18, 1989).

170 Sean Griffith attributes such survivability, at least in the case of the Chicago Mercantile Exchange (CME), to government intervention. Griffith, *supra* note 12, at 1350 n.285. This proposition is debatable, however, in securities markets.

171 Bernanke, *supra* note 62, at 146–47; James Bullard et al., *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RES. BANK ST. LOUIS REV. 403, 407–08 (2009), http://research.stlouisfed.org/publications/review/09/09/part1/Bullard.pdf; Roe, *supra* note 54, at 1652–53, 1688.

participant cross monitoring,[172] risk management,[173] and interconnected, shared financial exposure.[174] First, defaults may accumulate and affect several interlinked clearinghouses. Second, in a crisis, clearing also may be in peril if information losses are considerable. The information loss problem may be compounded by large trading volumes and price volatility, circumstances that were emblematic of the 1987 crash,[175] or low asset prices and "information contagion" regarding individual parties' exposure to various assets,[176] an issue also characteristic of the 2008 financial crisis.

Clearing utilities, self-evidently, are generally aware of such risks and pertinent operational concerns. To tackle these issues in the past, for instance, they set up incremental information sharing programs, such as the Monitoring Coordination Group established in 1984.[177] The limited objective of the Group was improving transparency and risk assessment through mutual information disclosure regarding common participants. Such initiatives were partial and incomplete, although they did contribute to default identification and loss mitigation during the 1987 market crash.[178]

The resultant postcrash game strategy was in line with the previous reforms. In keeping with the U.S. tradition of postcrisis diagnostics, a plethora of postcrash studies detailed its causes.[179] The identified set of

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172 Clearing agencies in 1987 also faced difficulties related to assessing the exposure of their clearing members to other markets and asset classes. BRADY COMMISSION REPORT, *supra* note 67, at 55 (on clearinghouse interconnectedness); GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 17–19.

173 If there are multiple CCPs, some structural problems become endemic. Risk management in certain cases might be easier if there were just one single CCP serving various asset markets and participants. *See, e.g.*, Manmohan Singh, *Collateral, Netting and Systemic Risk in the OTC Derivatives Market* 3–4, 8–9, 12 (Int'l Monetary Fund, Working Paper No. 10/99, 2010), http://www.imf.org/external/pubs/ft/wp/2010/wp1099.pdf; *see also* Duffie & Zhu, *supra* note 64. In addition, if multiple markets for derivatives and securities are interlinked, clearing participants may operate in two or more markets, complicating risk assessments. GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 17–19; Order Approving Proposed Rule Changes, 1989 WL 550672, at *4 n.26; discussion *supra* note 172.

174 Order Approving Proposed Rule Changes, 1989 WL 550672, at *4 (discussing the "operational and financial exposure" of clearinghouses).

175 GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 17–24; Order Approving Proposed Rule Changes, 1989 WL 550672, at *5 & n.45 (citing U.S. SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK, *supra* note 57, at 10-25 to -26).

176 Roe, *supra* note 54, at 1653, 1688.

177 Order Approving Proposed Rule Changes, 1989 WL 550672, at *6 (mentioning that the group's communication "procedures appl[ied] whenever a common participant's financial condition [was] deemed to threaten the financial or operational condition of clearing members, clearing agencies, or marketplaces").

178 *Id.*

179 The studies covered, inter alia, further centralization and interconnectedness of C&S services in different markets, the need for better information exchange among registered agencies, wider immobilization of securities, improvements in the guarantee, margin, and fees policies, and other issues. *See generally* 15 U.S.C. § 78q-1(f) (2012); *The Market Reform Act of*

issues and private sector solutions dominated further regulatory developments. For instance, the President's Working Group was urged to consider private courses of action,[180] while the SEC was directed to improve coordination in clearing of various assets classes, which was a specific and targeted response to the crash.[181]

The Commission also received the emergency authority to suspend registration or impose additional requirements to prevent market disruptions and to ensure "safe clearance and settlement."[182] That new statutory mandate was broad. Nevertheless, the SEC, acting in consonance with Postulate I, preserved the generalized 1980 risk management standards, which thus generally survived until the major post–Dodd-Frank overhaul in 2012.[183]

Most post-1987 proposals effectively translated into incremental, targeted initiatives. Those spanned the introduction of a shorter settlement cycle; better industry programs, such as the Securities Clearing Group, an organization working on improving information exchange on financial positions of clearing members and ensuring, inter alia, better member monitoring and timetable synchronization; information and cross-guaranty programs spearheaded by the leading clearinghouses; and other initiatives.[184]

1989: Joint Hearings on S. 648 before the S. Subcomm. on Sec. and the S. Comm. on Banking, Hous., & Urban Affairs, 101st Cong. 225 (1989) (statement of Nicholas F. Brady, Sec'y, U.S. Dep't of the Treasury); INT'L BUS. MACHINES CORP., STUDY OF CLEARANCE AND SETTLEMENT FOR THE U.S. CONGRESS—OTA (1989); OFFICE OF TECH. ASSESSMENT, *supra* note 69, at 107–17; BRADY COMMISSION REPORT, *supra* note 67, at 69; GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 33–34, 38–39, 48.

180 The President's Working Group on Financial Markets was mandated to consider this option. Exec. Order No. 12631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

181 Market Reform Act of 1990, Pub. L. No. 101-432, sec. 5, § 78q-1, 104 Stat. 963, 973 (codified as amended at 15 U.S.C. § 78q-1(a)(2)(A) (2012)) (directing the SEC "to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options").

182 15 U.S.C. § 78l(k)(2).

183 *See, e.g.*, Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66226 & n.72 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

184 *See generally* Notice of Immediate Effectiveness of Proposed Rule Change Relating to Collateral Management Service, Exchange Act Release No. 55391, 2007 WL 1260821 (Mar. 2, 2007); Order Approving a Proposed Rule Change Establishing the Collateral Management Service, Exchange Act Release No. 36091, 1995 WL 493313 (Aug. 10, 1995); Order Approving Proposed Rule Changes, Exchange Act Release No. 27044, 1989 WL 550672, at *6 (July 18, 1989); Securities Transactions Settlement, Securities Act Release No. 8398, Exchange Act Release No. 49405, Investment Company Act Release No. 26384, 69 Fed. Reg. 12922-01 (proposed Mar. 18, 2004); MARKHAM & HAZEN, *supra* note 150; OFFICE OF TECH. ASSESSMENT, *supra* note 69, at 109–17, 121; Notice from Executive Risk Management, Nat'l Sec. Clearing Corp., to All Members, Nat'l Sec. Clearing Corp. (Nov. 1, 2010), http://164.109.172.95/downloads/legal/imp_notices/2010/nscc/a7089.pdf.

3. Rule Generality

This traditional reform cycle and market-regulator cooperation were complemented by another important observable trend—the generality of the regulatory language completing Postulate I. Consider that securities law sets forth such SEC guideposts as the safety and efficiency of the national C&S system in very broad strokes.[185] The SEC's authority is, as is typical, extensive. The Commission registers the clearinghouses and has broad discretion in regard to approval of SRO rules and proposed rule changes.[186] The overarching statutory objectives are investor protection, promotion of market efficiency, possible effects on competition, and capital formation concerns.[187]

This language, ex hypothesi, enables the SEC to monitor and control the direction and developments within the C&S industry very closely,[188] viz., had the SEC decided to do that, it could have exercised much closer oversight, minutely dissecting all clearinghouse rules and procedures. After all, as the Ninth Circuit Court of Appeals observed, while "Congress enacted Section 17A precisely for the purpose of replacing an inefficient and outmoded system of clearing agencies with a more modern and efficient system[,] . . . . [it] did not impose any specific standards of efficiency," emphasizing the reliance on the SEC in regulating clearinghouses.[189]

Despite such statutory generality, the SEC almost ab initio chose to issue somewhat low-key C&S "standards to be used by the Division of Market Regulation."[190] Similarly, in its original registration rule, registration orders, and later initiatives, the SEC set forth more

185 *See, e.g.*, LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 802–05 (5th ed. 2004); Wolkoff & Werner, *supra* note 15, at 324–26 (discussing the statutory language).

186 15 U.S.C. § 78s.

187 15 U.S.C. § 78c(f); 15 U.S.C. § 78s; 17 C.F.R. § 240.19b-4 (2015).

188 A good supporting example is the antitrust arguments related to the formation of the NSCC. Recall that the court in *Bradford* was very generous to the SEC in this respect. Bradford Nat'l Clearing Corp. v. Sec. & Exch. Comm'n, 590 F.2d 1085, 1107 (D.C. Cir. 1978).

189 Whistler Invs., Inc. v. Depository Tr. & Clearing Corp., 539 F.3d 1159, 1167 (9th Cir. 2008).

190 Regulation of Clearing Agencies, Exchange Act Release No. 16900, 45 Fed. Reg. 41920 (June 23, 1980) (to be codified at 17 C.F.R. pt. 241). This is also consistent with the original exchange regulation. *See, e.g.*, Silver v. N.Y. Stock Exch., 373 U.S. 341, 352 (1963) ("The pattern of governmental entry, however, was by no means one of total displacement of the exchanges' traditional process of self-regulation. The intention was rather, as Mr. Justice Douglas said, while Chairman of the S.E.C., one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" (quoting DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS AS MEMBER AND CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION 82 (James Allen ed., 1940))).

generalized overarching principles focusing on the creation of a truly national interlinked C&S system and on facilitating both interconnectedness and horizontal integration within the industry.[191]

The first standards were short and may be characterized as principles based. These guidelines included, inter alia, the previously discussed nondiscriminatory participation standards,[192] permitting "discrimination" only on the grounds of objective criteria;[193] fair representation policies;[194] and an assortment of supporting requirements ranging from governance procedures to transparency rules.[195] The major clearing agencies did not encounter significant compliance problems in this respect.[196]

C. *The Interplay of Postulates I and III: Industry Concentration and Corporate Governance*

1. Industry Consolidation and New Entrants

a. The Industry Structure

The existence and durability of Postulate I is further demonstrated by minimal regulatory intervention into industry concentration processes.[197] This noninterventionism was a recursive method since the virtual monopoly in C&S was already in existence in the 1970s and deepened in the following decades. Namely, the Options Clearing Corporation (OCC) became the key options clearinghouse and, as of 1997, the NSCC was already clearing and settling ninety-eight percent of all equity, corporate, and municipal bond transactions, with the DTC transferring securities and serving as a custodian for most broker-

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191 *See, e.g.*, 15 U.S.C. § 78q-1(a); *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1099; Order, Exchange Act Release No. 20221, 48 Fed. Reg. 45167-02 (Sept. 23, 1983); Proposed Rule Change, Exchange Act Release No. 14109, 42 Fed. Reg. 58991-01 (Nov. 14, 1977).

192 Regulation of Clearing Agencies, 45 Fed. Reg. at 41921 (discussing pertinent criteria).

193 *Id.* at 41921–22.

194 *Id.* at 41923–24.

195 *Id.* The other requirements included, for example, adequate disciplinary procedures, *id.* at 41924, and promotion of prompt and accurate C&S, *id.* at 41925, including having effective organizational and processing capabilities, rules on clearing fund contributions, and liquidity. *Id.* at 41929.

196 *See, e.g.*, Order, Exchange Act Release No. 20221, 48 Fed. Reg. 45167-02 (Sept. 23, 1983); Order Granting Registration and Statement of Reasons, 42 Fed. Reg. 3916-01, 3922, 3924–29, 3938 (Sec. & Exch. Comm'n Jan. 21, 1977); Notice of Institution of Proceedings to Determine Whether to Grant or Deny Registration as Clearing Agencies, Exchange Act Release No. 12759, 41 Fed. Reg. 38841-01 (Sept. 13, 1976).

197 Not only did the SEC endorse the NSCC, it also urged the spinoff of the OCC as a centralized clearinghouse for all options exchanges. Hence, the decision coincided with the overhaul in options trading. *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 378.

dealers and banks.[198] The DTCC's subsidiaries, including the NSCC and the DTC, still "clear and settle nearly all US market trades in equities, corporate and municipal bonds, government securities and mortgage-backed securities, money market instruments and OTC derivatives."[199]

By contrast, smaller clearing agencies and depositories gradually perished.[200] In 2008, Nasdaq OMX acquired the last remaining facilities, the Boston Stock Exchange Clearing Corporation and the Securities Clearing Corporation of Philadelphia,[201] thus effectively making the NSCC the only securities CCP. The DTC, obviously, is the sole CSD in the United States.[202] Both of them and the OCC have been designated under Title VIII of Dodd-Frank as systemically important "[f]inancial market utilities . . . [, i.e.,] multilateral systems that provide the [essential] infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and the system."[203]

Any basic textbook in economics warns that market concentration may add a layer of risk associated with the lack of competition. Notwithstanding this risk, the SEC by and large refrained from intervening in the market organization throughout the post-paperwork-crisis history of the C&S industry. The explanations of this abstention bring Postulate III to the fore. In short, the market was efficiently self-regulated.

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198 GAO, PAYMENTS, CLEARANCE, AND SETTLEMENT, *supra* note 64, at 48. Already in the 1980s–1990s, the NSCC was a major clearinghouse, while only three clearinghouses worked with several securities exchanges and with OTC equity markets. GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 11; Order Approving Proposed Rule Changes, Exchange Act Release No. 27044, 1989 WL 550672, at *5–6 (July 18, 1989); U.S. SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK, *supra* note 57, at 10-2 n.2; Bernanke, *supra* note 62, at 135. The NSCC was ab initio the principal clearing agency, which had the necessary capacity for continuous net settlement and served as a public utility. Bradford Nat'l Clearing Corp. v. Sec. & Exch. Comm'n, 590 F.2d 1085, 1101, 1108 (D.C. Cir. 1978).

199 DTCC, THE US MODEL FOR CLEARING AND SETTLEMENT, *supra* note 110, at 2; *see also* Pet Quarters, Inc., v. Depository Tr. & Clearing Corp., 559 F.3d 772, 776–77 (8th Cir. 2009).

200 There technically are only four active securities and options clearing agencies. Proposed Collection, 76 Fed. Reg. 16018-01, 16018 (Sec. & Exch. Comm'n Mar. 22, 2011).

201 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-318R, SECURITIES AND EXCHANGE COMMISSION: OVERSIGHT OF U.S. EQUITIES MARKET CLEARING AGENCIES 15 (2009), http://www.gao.gov/products/GAO-09-318R.

202 The list of the registered clearing agencies is available online. *Self-Regulatory Organization Rulemaking*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/rules/sro.shtml (last updated Apr. 4, 2016). The very development of modern securities clearing became "inseparably linked to the establishment of a centralized national clearing agency, the [NSCC], operating in tandem with a centralized securities depository, the [DTC]." Minnerop, *supra* note 99, at 932 n.67.

203 *Designated Financial Market Utilities*, BOARD GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/paymentsystems/designated_fmu_about.htm (last updated Jan. 29, 2015).

To recap, the summary of Postulate III is as follows: First, within the existing imperfectly contestable monopoly environment, other entities have an opportunity and right—even if theoretical—to join the industry. Second, the regulated market entities are efficiently monitored by key market constituencies through participatory corporate governance mechanisms.

b. A Contestable Monopoly

The 2008 Nasdaq acquisition of the Philadelphia and Boston clearinghouses typifies examples of the first prong of Postulate III. The acquisition represents a crucial and unmistakable antimonopoly backstop targeting inefficient pricing and lack of innovations. It challenged the DTCC's monopoly insofar as Nasdaq could and did intend to set up a new CCP using its newly acquired subsidiaries as a launching pad.[204] In 2009, however, Nasdaq abandoned the plans. Its stated reasons were fully consistent with the contestable monopoly arguments: the DTCC had taken into consideration the threat of potential competition and sufficiently improved clearing pricing and services. Thus, product and service improvements were achieved without Nasdaq actually engaging in competition.[205]

This incident demonstrates a market structure with some features of a contestable monopoly. Even though the barriers to entry are admittedly high,[206] market entry is feasible. Such *potential* competition should produce a positive impact on underlying industry practices and products.

The law and SEC's regulations do not preclude competition among clearing facilities. In fact,

> [s]ection 23(a) of the Exchange Act requires the Commission, when making rules and regulations under the Exchange Act, to consider the impact a new rule would have on competition. Section 23(a)(2) of the Exchange Act prohibits the Commission from adopting any rule

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[204] *NASDAQ OMX Announces Its Intent to Launch the NASDAQ Clearing Corporation*, NASDAQTRADER.COM (Oct. 8, 2008), https://www.nasdaqtrader.com/traderNews.aspx?id=HTA2008-116.

[205] *Nasdaq OMX Abandons US CCP Plans*, TRADE (Oct. 30, 2009), http://www.thetradenews.com/news/Regions/Americas/Nasdaq_OMX_abandons_US_CCP_plans.aspx ("Nasdaq OMX said it had rethought its approach because it believes the threat of competition to the DTCC had achieved the exchange's intended aims of lowering the cost of US equities trading, improving service and efficiencies and promoting innovation.").

[206] *See, e.g.*, Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29576 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240) (acknowledging the problems associated with high barriers to entry and consolidation in the C&S industry).

> that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[207]

Consequently, in its rule making, the Commission does pay attention to the effect on barriers to entry, while some commissioners have underscored the value of competition in clearing.[208] From a regulatory perspective, the clearing market thus may appear contestable.

At the same time, the SEC balances antitrust arguments against industry costs and benefits. It argued, for instance, that it "is not required to achieve its regulatory objectives in the least anticompetitive manner and is at most required to decide that any anticompetitive effects of its actions are necessary or appropriate to the achievement of its [general] objectives."[209]

The resultant policy outcome is the described market-driven monopoly. This outcome derives in part from a pure economic analysis, and in part from the practicalities. For one, the SEC evidently took into account the contestable markets theory, focused on entry and exit costs, and attempted to combine *centralized* clearing with *competitive* trading rules.[210] In a similar vein, the practicalities dictated that positive network externalities and economies of scale and scope would lead to a reduction in duplicate customer fees, lower per unit transaction costs, greater transaction volume, and considerable cost savings, all accruing to the benefit of investors and the financial industry.[211] The growth of the

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207 Amendment to Rule Filing Requirements for Dually-Registered Clearing Agencies, Exchange Act Release No. 69284, 78 Fed. Reg. 21046-01, 21052–53 (Apr. 9, 2013) (to be codified at 17 C.F.R. pts. 240 and 249) (footnote omitted).

208 *See, e.g.*, *id.* at 21054 ("[T]his rule does not increase barriers for new clearing agencies."); *see also* Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. at 29514 (mentioning providing "a more flexible regime for new entrants"). As discussed above, SEC Chairman Garrett originally expressed concerns about the lack of competition among CCPs. This issue, albeit dormant, was not completely ignored by the Commission. *See* Wolkoff & Warren, *supra* note 15, at 322.

209 Order Granting Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange to Withdraw from the Securities Depository Business and to Restructure and Limit Its Clearance and Settlement Business, Exchange Act Release No. 39444, 62 Fed. Reg. 66703-01, 66705 (Dec. 11, 1997).

210 Some SEC studies reveal that the Commission was aware of and relied on the contestable markets theory, stating that competition depends primarily on the feasibility and ease of market entry and exit. *See, e.g.*, Multiple Trading of Standardized Options, Exchange Act Release No. 26870, 1989 WL 550695, at *3 (May 26, 1989) (to be codified at 17 C.F.R. pt. 240); Wolkoff & Werner, *supra* note 15, at 374 (reviewing competitive trading in conjunction with interlinked and centralized clearing).

211 *See, e.g.*, BAGLIONI & HAMAUI, *supra* note 23, at 7–9 (discussing the benefits of a single clearinghouse and CSD, network externalities, and supply side arguments). The monopolies also emphasized that increasing the number of qualified agency participants amplifies "transaction volumes [and] reduce[s] per-unit service costs that must be recovered through participant service fees." Notice of Filing of a Proposed Rule Change Relating to a Decision by CSE to Withdraw from the Clearance and Settlement, Securities Depository, and Branch Receive Businesses, Exchange Act Release No. 36547, 1995 WL 733308 (Dec. 1, 1995); *see also*

monopolies also eliminated redundant interagency interfaces, reduced maintenance costs, and improved communication networks. Perhaps for these reasons, smaller CCPs and CSDs voluntarily withdrew from the market. Following their withdrawal, the surviving monopolies forthwith extended C&S services to the members of the exiting clearinghouses.[212]

From this perspective, it is understandable why the SEC might find the ongoing consolidation appropriate and the foregoing reasons persuasive—the actual effects of a contestable monopoly in clearing comported with the interests and objectives of the securities regulator. As a result, the SEC, on occasion, expressed its belief that "the . . . regulatory scheme and the particular structure and nature of the clearing and depository industries provide ample means of avoiding the potential negative effects of a monopoly,"[213] allowing the C&S industry to provide high quality and low cost services.

2. Market Self-Monitoring and Corporate Governance

Unfortunately, contestable monopolies can be fragile organizational structures.[214] The ensuing concern is that the regulator should believe that the essentially monopolistic clearing facilities would not extract monopoly rents, charge the trading community high fees, or,

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Order Granting Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange to Withdraw from the Securities Depository Business and to Restructure and Limit Its Clearance and Settlement Business, 62 Fed. Reg. at 66705; Notice of Filing of a Proposed Rule Change Relating to a Decision by the Philadelphia Stock Exchange to Withdraw from the Clearance and Settlement and Securities Depository Businesses, Exchange Act Release No. 39220, 62 Fed. Reg. 53848-01, 53849 (Oct. 8, 1997).

212 *See, e.g.*, Order Granting Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange to Withdraw from the Securities Depository Business and to Restructure and Limit Its Clearance and Settlement Business, 62 Fed. Reg. 66703-01; *see also* Notice of Proposed Rule Change to Amend the Articles of Organization and By-Laws of the Boston Stock Clearing Corporation, Exchange Act Release No. 63629, 76 Fed. Reg. 1473-02 (Jan. 3, 2011) (discussing the dormant status of the Boston clearinghouse, BSECC); Order Granting Request for Withdrawal from and Cancellation of Registration as Clearing Agency, Exchange Act Release No. 47061, 67 Fed. Reg. 79172-01 (Dec. 20, 2002).

213 Order Granting Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange to Withdraw from the Securities Depository Business and to Restructure and Limit Its Clearance and Settlement Business, 62 Fed. Reg. at 66705.

214 Mergers and changes in ownership may disturb the system, allowing an entity to appropriate monopoly rents. *See, e.g.*, Serifsoy & Weiß, *supra* note 21, at 28 ("Like the system of competitive fragmentation, the system of contestable monopolies is prone to deteriorate when even small deviations from the consistent configuration occur. The micro-motives of the infrastructure provid[ing institutions] will generally lead to a situation in which a monopoly prevails that is entrenched through vertical integration, a proprietary communication standard, and an ownership structure that places too little weight on the benefit of the users and society as a whole.").

for instance, impose inadequate margins and other risk management standards *in the long term*. What then made the SEC view the mergers and resultant monopolies favorably for more than several decades? This brings us to the second prong of Postulate III—the signals sent through the self-regulatory and governance structure of the clearing monopolies.

Let us consider them in turn. The first is the OCC. When it was created in the 1970s, it became a de facto industry utility financed through clearing fees shared by its constituent exchanges.[215] Today, it "clears all standardized options listed on the twelve U.S. national securities exchanges . . . and . . . CFTC-regulated futures products for four U.S. futures exchanges."[216]

Even though it is not a typical vertical silo, several exchanges still own OCC shares. And yet, its board of directors is dominated by clearing and independent members.[217] The current board of directors of the OCC is comprised of twenty-one members, *nine* of whom represent clearing members (i.e., the users of its own services), and five are public directors.[218]

The second example is the DTCC, whose corporate governance is similarly predicated on the foundational principles of the fair representation of participants and on serving broad stakeholder constituencies. The constituencies of the DTCC include not only shareholders, but also "its financial institution participants, their issuer and investor clients and the governmental and supervisory authorities responsible for the global clearance and settlement systems."[219]

These overarching principles are incorporated into the Board's Charter and bylaws. Pursuant to section III of the Board's Charter, between fifteen and twenty-five directors are elected annually.[220] The majority of the directors, currently eleven out of eighteen,[221] represent

215 *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 340–43 (discussing the creation of centralized options clearing in the 1970s and the central role of the SEC, which after public hearings in 1974 urged all interested exchanges to work together toward creating a unified and standardized options clearing infrastructure). Instead of clearing, there were antitrust concerns regarding options exchanges, which were resolved only in 2000, leading to a decrease in clearing and trading fees, and increased trading volume in the following years. *Id.* at 371–73.

216 2014 OCC Letter, *supra* note 24, at 2.

217 OPTIONS CLEARING CORP., STATEMENTS FROM A FORWARD-LOOKING COMPANY: 2010 ANNUAL REPORT 12, http://www.theocc.com/components/docs/about/annual-reports/occ_2010_annual_report.pdf; 2014 OCC Letter, *supra* note 24.

218 OPTIONS CLEARING CORP., BOARD OF DIRECTORS CHARTER (2015), http://www.optionsclearing.com/components/docs/about/corporate-information/board_of_directors_charter.pdf.

219 BD. OF DIRS., DEPOSITORY TR. & CLEARING CORP., CHARTER 6 (2015) [hereinafter DTCC CHARTER].

220 *Id.* at 4.

221 *DTCC Board of Directors*, DEPOSITORY TR. & CLEARING CORP., http://www.dtcc.com/about/leadership/board.aspx (last visited Feb. 13, 2016).

clearing participants, while two directors are nominated by the NYSE and FINRA, the independent securities regulator. This structure, ex hypothesi, optimizes the risk and monitoring incentives inasmuch as "participant shareholders . . . by virtue of making deposits to a clearing fund or otherwise, share the risk of loss associated with settlement defaults or other clearing agency losses"[222] *and* take part in the management.

Thus, the multistakeholder corporate governance model should help, at least in theory, the market and the regulator verify the quality of the signals sent by the clearinghouses. It also lends support to the avowed objectives of clearinghouses. The DTCC, for instance, points out that it "serves a broad range of constituencies"[223] and ensures "user-pays" transparency and transparent customer ownership.[224]

These governance signals were naturally bolstered on the revenue side by a supplementary signaling device—the "at-cost basis [revenue model], returning excess revenue from transaction fees to its member firms."[225] Similar to the DTCC, the OCC routinely set its fees "to cover its operating expenses and to maintain such reserves as [were] deemed reasonably necessary by OCC's Board of Directors to . . . [serve] its exchanges, its clearing members and the general public" and refunded excessive fees to the members.[226]

D. *Conclusion*

When one examines the C&S industry, the sector-specific financial regulation seems devoid of its negative modern connotation. On the one hand, the information loss and regulatory oversight problems were mitigated through market-regulator cooperation. On the other hand, the regulator's behavior followed a familiar pattern: after a crisis, generalized regulations merely gave impetus to already emerging best industry practices. There was a consensus, at least in principle, on what those best practices should be, and the regulator threw its support behind the market consensus.

The second trend was structural. First, the industry gradually evolved into a contestable monopoly, kept in check by a potential threat of future competition. Second, the multistakeholder model of corporate governance forged more efficient and reliable market self-monitoring

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222 DTCC CHARTER, *supra* note 219, at 6.

223 *Id.*

224 DTCC, THE US MODEL FOR CLEARING AND SETTLEMENT, *supra* note 110, at 7, 13–19.

225 *Id.* at 6.

226 2014 OCC Letter, *supra* note 24, at 13 (also discussing fee refund changes in response to new regulations).

arrangements and, hypothetically, allowed the sector-specific regulator to economize on the oversight costs and preserve principles-based regulations.

IV. Postulates II and IV: Ex Post Enforcement Policies and Predictability

A. *Postulate II: SEC Enforcement*

Similar to the SEC's principles-based industry-mimicking policies, the same restraint was evident in its post-1975 enforcement strategies. There were merely two major actions against clearinghouses, illustrating that the SEC did not exercise its regulatory authority frivolously and instead focused its attention on blatant transgressions. The two actions discussed below were the primary examples of regulatory noncompliance.[227] Both could undermine the integrity of the national C&S system, its commitment to providing cheaper post-trading services, and the confidence of market participants in the interconnected clearinghouses.

First, recall that the regulations established, inter alia, general requirements for clearing fund safety and adequate margining.[228] In the order granting registration to the Stock Clearing Corporation of Philadelphia (SCCP), the SEC expressed concerns that the SCCP offered loans and margin-financing services to participants and the Philadelphia Stock Exchange (PHLX) specialists.[229] The SCCP's loan policies might exacerbate the financial exposure of the SCCP itself and of its participants.[230] However, after careful evaluation, the SEC did approve the loan program in light of the associated benefits to the SCCP, its participants, the trading community in general, and, in particular,

227 The third action was less relevant to this analysis. It concerned trading and margin call manipulations by Boston Stock Exchange specialists and the resulting violations of margin, net capital, and bookkeeping requirements. For these activities, "the Clearing Corp [as a subsidiary of BSE] issued margin calls, but did not adequately monitor margin compliance despite frequent margin calls which were generally outstanding for the maximum five-day period. . . . [T]he parking could have been detected by reviewing documents in the Clearing Corp's possession." Bos. Stock Exch., Inc., Exchange Act Release No. 17183, 1980 WL 25454, at *3 (Oct. 1, 1980) (order). The violations were in fact discovered by the internal auditor of the *clearinghouse* and reported to the Exchange, which commenced an internal investigation. *Id.* at *4.

228 *See* 15 U.S.C. § 78q-1(b)(3) (2012); Regulation of Clearing Agencies, Exchange Act Release No. 16900, 45 Fed. Reg. 41920 (June 23, 1980) (to be codified at 17 C.F.R. pt. 241).

229 Order, Exchange Act Release No. 20221, 48 Fed. Reg. 45167-02, 45174–76 (Sept. 23, 1983).

230 *Id.* at 45176.

exchange specialists.[231] As a precaution, the Commission requested the SCCP to improve its rules with respect to participants' financial stability and to establish stricter financial safety procedures.[232]

Yet, analogous concerns resurfaced fifteen years later in the 1997 cease-and-desist proceedings instituted against the SCCP and its sister depository, Philadep.[233] In part, the violations stemmed from the direct ownership of the C&S entities by the PHLX. By 1997, the Exchange was routinely covering temporary cash deficits using funds from the clearing subsidiaries. The agencies also failed to comply with pertinent rules regarding contributions, participants' fund deposits, collateral, and margin requirements.[234]

In the second major action, the SEC brought suit against Midwest Clearing Corporation (MCC) and Midwest Securities Trust Company (MSTC).[235] The defendants created two interlinked accounts, the second of which effectively was a computer entry representing false securities positions that the defendants merely "anticipated receiving from their participants and which were, in turn, due to be delivered to [other clearinghouses] for settlement of sales transactions executed by such participants."[236] The contra clearing corporations, informed that timely deliveries had been made, would make payments prior to the actual receipt of the securities by MCC and MSTC and before MCC had to pay the sellers. The defendants invested the resulting cash float, "eventually amount[ing] to as much as $35 million a day," and also used it as a source of low interest loans to MSTC.[237]

This brief overview demonstrates the fundamental dormancy of the regulator, awakening mainly to prosecute more serious violations that undermined the structure and organization of the C&S model. This low regulatory frequency may seem even unusual considering that the SEC is generally recognized as an exceptionally active securities market

231 *Id.*

232 *Id.* at 45176–77.

233 Stock Clearing Corp. of Phila., Exchange Act Release No. 38918, 1997 WL 457495 (Aug. 11, 1997) (order instituting proceedings).

234 The violations, inter alia, concerned the rules requiring that participant funds be safeguarded. *Id.*; *see also* Briggs, Exchange Act Release No. 40506, 1998 WL 668156 (Sept. 30, 1998) (order instituting proceedings) (pursuing an action against the Chief Financial Officer of the Philadelphia Stock Exchange, who also was the Chief Financial Officer of the respondent agencies); Guiheen, Exchange Act Release No. 38917, 1997 WL 457493 (Aug. 11, 1997) (order instituting cease-and-desist proceedings) (pursuing an action against the President and CEO of the respondent agencies).

235 Sec. & Exch. Comm'n v. Midwest Clearing Corp., No. 92CV07191, 1992 WL 12617990 (N.D. Ill. Oct. 29, 1992).

236 *Id.* para. 11.

237 *Id.* para. 13.

regulator in the world.[238] In clearing, the SEC equally had an opportunity to tighten the regulatory valves relying on its broad statutory mandate and construing it as a form of carte blanche.

Possible explanations for the low enforcement activity and for the SEC's refraining from clearinghouse micromanagement are consistent with the conclusions of Part II of this Article. Namely, clearing agencies and, in particular, the leading facilities, performed relatively well *and* their potential transgressions were adequately controlled through internal corporate governance mechanisms. A successful market-regulator equilibrium was formed.

The violators were operating as peripheral clearing institutions at the time of the enforcement actions. Moreover, after the enforcement actions, the culprits gradually exited the industry, having first merged their operations into other clearinghouses.[239] By contrast, not only did the NSCC and the DTC dwarf the size and operations of the violators, but also both of these larger entities successfully avoided becoming the epicenter of major enforcement efforts. This, again, implies their stability, successful market self-monitoring, and proper market-regulator interaction. Theoretically, such arrangements allowed the SEC to economize on the regulatory oversight resources.

B. *Postulate IV: Courts and Clearing Agencies*

1. Introduction: Judicial Noninterventionism and Its Factual Premises

To confirm this pre–2008-crisis market-regulator equilibrium, I reviewed all cases involving clearing agencies.[240] Recall that courts comprise Postulate IV of the market-regulator arrangement involving one sector-specific expert regulator and stakeholder-controlled market entities (i.e., Postulates I, II and III). The only prong that may disturb the extant equilibrium is courts. This Section exemplifies how this third side of the arrangement props up the market-regulator interaction. Even though this support is not a normative predicate of judicial philosophy, it has been nontrivial.

From a positivist perspective, the constitutive elements of the existing trends may be taxonomized within a structure effectively representing a confluence of factors. Those factors touch upon both C&S economics and regulatory predicates. Specifically, so long as a

238 *See, e.g.*, John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 260–85 (2007); Coffee & Sale, *supra* note 4, at 728–29.

239 *See, e.g.*, Stock Clearing Corp. of Phila., 1997 WL 457495, at *8.

240 The few suits brought by clearinghouses were excluded from the sample.

clearinghouse stays within the preapproved boundaries of SRO and SEC programs and rules, and exercises its discretion in good faith, courts seem reluctant to interfere with the established market-regulator arrangements. Instead, they rely on the implied integrity of the clearing rules using the SEC's approvals as a proxy.

Accordingly, as I briefly mentioned in Section II.B, there is a clear dichotomy between court decisions concerning such preapproved *public* programs and clearing functions on the one hand, and *self-interested* actions of a clearinghouse as a private corporation on the other. This effective bifurcation is elegant in its simplicity—judicial analysis flawlessly comports with the dichotomous nature of the industry.

To elucidate the idea, it is appropriate to distinguish actions falling *within* the ambit of some regulator-approved rules and programs, viz., Postulate I, from opportunistic *private* actions of any private entity, including a clearinghouse. An example of the former would be the actual clearing services and programs. The latter might be a license agreement, a basic sales contract, or even a conference call with certain market participants in which parties discuss projections or internal operations.

This latter set of minor operations and management decisions fall *outside* the preapproved range of behavior. Nor are they fully controlled by the parallel corporate governance and market monitoring backstops (i.e., Postulate III). Indeed, market participants primarily share the risks of *clearing* services and consequently are more concerned about the integrity of clearing qua clearing.

Hence, there is always a window of opportunity for opportunism in day-to-day management, which elides both the cooperative market-regulator interaction *and* market self-monitoring. In an attempt to receive short-term gains, a private entity, tempted by opportunism, imposes negative externalities on the rest of the market. It is necessary for either courts or regulators to act in such circumstances.

This dual understanding of the clearing agencies is implicitly embedded in case law; that is, the cases in the next Section distinguish the "equilibrium cases" from opportunistic actions. The pertinent policy arguments may be classified as follows:

Equilibrium Cases	Contiguous Operations
Public Functions: 1. Efficiency and integrity of the national C&S system 2. Federal Preemption Arguments 3. Centrality of the SEC's role as a securities market regulator	Transactional & Private: 1. Contractual breach 2. Opportunism

2. The Sample Cases: 1975–2014

The research conducted for this Article covered all clearing agencies that were registered with the SEC in the past, as well as the currently registered facilities. Correspondingly, the timeframe was from 1975, the year of the major statutory reform following the back office crisis, to August 2014. Many cases were excluded from the sample as unrelated to the primary functions and structure of the securities clearinghouses. The irrelevant subject matter included, inter alia, employment-related and sexual harassment claims, and futures market manipulation.

Decisions where the Intercontinental Exchange's (ICE's) and the Chicago Mercantile Exchange's (CME's) clearinghouses were a party were also excluded. Both clearinghouses are derivatives clearing organizations primarily within the jurisdiction of the CFTC. Including these two agencies would have distorted the analysis of the traditional cooperative arrangements among the SEC, courts, and the securities clearinghouses.

The analysis below also purposely omits five other cases. One court focused on the first-filed rule analysis,[241] and ultimately, another court granted DTC's motion to dismiss, meaning that both were de facto related to the same dispute.[242] The other two suits involved (a) the Chicago Board Options Exchange (CBOE) and the CME, on one side, and the International Securities Exchange (ISE) and the OCC, on the other;[243] and (b) Dow Jones and, again, the ISE and the OCC.[244] In those cases, the primary parties were exchanges and Dow Jones, sparring for the right to trade and profit from ETF and index options, not the clearinghouse. In the first case, the court did not reach the merits of the OCC injunction to clear such options.[245] In both decisions, the clearinghouse-related part depended, to a large extent, on the outcome of the underlying misappropriation, unfair competition, and intellectual property claims with respect to the new options.[246]

The fourth case was dismissed purely on procedural grounds, and therefore, had to be excluded from the analysis. In that case, claims against Midwest Clearing Corporation were dismissed due to the

241 Sammons v. COR Clearing, No. 8:14CV136, 2014 WL 4656114 (D. Neb. Sept. 16, 2014) (granting DTC's motion to dismiss).

242 China Energy Corp. v. Hill, No. 3:13-cv-00562-MMD-VPC, 2014 WL 4633784 (D. Nev. Sept. 15, 2014) (granting DTC's motion to dismiss).

243 Chi. Bd. Options Exch., Inc. v. Int'l Sec. Exch., L.L.C., 973 N.E.2d 390 (Ill. App. Ct. 2012).

244 Dow Jones & Co. v. Int'l Sec. Exch., Inc., 451 F.3d 295 (2d Cir. 2006).

245 *See Chi. Bd. Options Exch.*, 973 N.E.2d 390.

246 *See Dow Jones & Co.*, 451 F.3d 295; *Chi. Bd. Options Exch.*, 973 N.E.2d 390.

plaintiff's failure to serve MCC.[247] In the fifth case, the NSCC was involved in a dispute between the Philadelphia Stock Exchange and one of its members, effectively as an agent holding the member's funds. Neither the District Court for the Eastern District of Pennsylvania nor the Court of Appeals for the Third Circuit devoted much of the precious judicial resources to discussing the NSCC's role in the dispute.[248]

Arguably, the last-mentioned two cases and the option indices cases might be indicative of the judicial understanding of C&S economics and the often ministerial role of a clearing conduit in a transaction. That is why one plaintiff "forgot" to serve MCC, while in the other cases courts were more preoccupied with the financial instruments traded on the ISE than with the OCC-related claims. Since this suggestion is conjectural, the foregoing cases were removed.[249]

Total	Positive	Negative	Procedural and Ministerial
24	17	2	5

Table 1: Sample Cases Summary

3. Positive Outcomes

The majority of the cases in the sample were related to *public* clearinghouse functions and generated positive outcomes for the clearing agencies involved. They also evince the confluence of procedural and substantive factors underpinning judicial noninterventionism.

Leaving aside general securities law claims and germane pleading standards, a hurdle for some plaintiffs particularly in Rule 10b-5 cases,[250] I would like to concentrate on the substantive analysis

247 Prevatte v. Nat'l Ass'n of Sec. Dealers, Inc., 682 F. Supp. 913, 914, 919 (W.D. Mich. 1988).

248 PennMont Sec. v. Frucher, 586 F.3d 242 (3d Cir. 2009); PennMont Sec. v. Frucher, 534 F. Supp. 2d 538, 540 (E.D. Pa. 2008).

249 Another excluded case comes from the era when securities processing was first developing and a securities transfer service failed to effect specific delivery instructions. Matthysse v. Sec. Processing Servs., Inc., 444 F. Supp. 1009 (S.D.N.Y. 1977).

250 *See, e.g.*, Cathedral Trading, LLC v. Chi. Bd. Options Exch., 199 F. Supp. 2d 851 (N.D. Ill. 2002) (reviewing the claim that the OCC and the CBOE prevented execution and clearing of trades and falsely blacklisted the plaintiffs as persons with a history of manipulative activity, and dismissing securities law claims for failure to comply with pleading requirements, and antitrust claims for failure to state a claim); Pompano-Windy City Partners, Ltd. v. Bear Stearns & Co., 794 F. Supp. 1265 (S.D.N.Y. 1992) (analyzing and dismissing multiple Securities Act and Exchange Act claims); Piemonte v. Chi. Bd. Options Exch., Inc., 405 F. Supp. 711 (S.D.N.Y. 1975) (analyzing the prospectus and finding no misleading statements or omissions).

specifically relevant to the clearing industry. The first cohort of such suits spanned the spectrum of market consolidation, antitrust claims, and the dangers of the lack of competition, as well as the counterbalancing benefits of centralization in C&S.[251]

Consider the first pertinent case, *Bradford*, where the District of Columbia Circuit Court affirmed the registration of the NSCC (i.e., a market leader in the making) in part, and remanded in part to the SEC for further consideration of some potentially anticompetitive NSCC programs.[252] It seems that the like-minded court and the SEC were in agreement and somewhat downgraded antitrust considerations vis-à-vis the benefits of the national C&S system and expert regulatory oversight. Incidentally, the court observed, albeit merely in a footnote, that although the statute "endorses the enhancement of competition[,] . . . it does so not in listing its 'objectives,' but instead in listing the factors for which the Commission is to have 'due regard' in achieving those objectives."[253]

Some later antitrust complaints targeted specific programs of centralized clearinghouses. In *Olde Monmouth*, for instance, the plaintiff averred "that DTC enjoy[ed] a monopoly over the entire securities depository industry."[254] When the plaintiff's application for participation in one DTC program was rejected, the plaintiff, a transfer agent, attempted to exert financial pressure on the DTC and raised various fees.[255] In response, the DTC reached out to the plaintiff's clients, complained about the fee increases, and considered "chilling" the issues for companies using that particular transfer agent.[256] The court, applying the Supreme Court test from *Grinnell*,[257] found that the DTC and transfer agents competed in different markets. Therefore, as a matter of law, the complaint failed to state a claim for monopolization of an "irrelevant" market,[258] regardless of the simple fact that

251 *See, e.g.*, Bradford Nat'l Clearing Corp. v. Sec. & Exch. Comm'n, 590 F.2d 1085 (D.C. Cir. 1978); Olde Monmouth Stock Transfer Co. v. Depository Tr. & Clearing Corp., 485 F. Supp. 2d 387 (S.D.N.Y. 2007) (dismissing antitrust claims); *Cathedral Trading*, 199 F. Supp. 2d at 858–62 (same); *see also infra* Section IV.B.4 (discussing Chapdelaine Corp. Sec. & Co. v. Depository Tr. & Clearing Corp., No. 05 Civ. 10711(SAS), 2006 WL 2020950 (S.D.N.Y. July 13, 2006)).

252 The court acknowledged that "NSCC is essentially a public utility that is afforded a monopoly but must offer its services to all qualified customers." *Bradford Nat'l Clearing Corp.*, 590 F.2d at 1101.

253 *Id.* at 1095 n.11 (quoting 15 U.S.C. § 78q-1(a)(2) (2012)).

254 *Olde Monmouth Stock Transfer Co.*, 485 F. Supp. 2d at 389, 392.

255 *Id.* at 390.

256 *Id.* at 390 n.4 ("A stop on physical processing is known in the industry as 'chilling' the issue.").

257 *Id.* at 392 (citing United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1966)).

258 The essential facility doctrine also failed as a matter of law. *Id.* at 395.

participation in the monopolistic programs of the DTC naturally was crucial to all market participants, including the plaintiff.[259]

Consider next that, as discussed in Section III.B.3, clearinghouses are SROs serving the national market and are registered with the SEC. Throughout case law, that market-regulator arrangement and endorsement of all clearinghouses' programs by the SEC have carried considerable weight with courts. One germane example is negligence claims and cases related to clearing agency operations, including the duty "to properly monitor" clearinghouse programs.[260]

These species of claims often fail as a matter of law. For instance, state negligence law standards might "interfere with the federally-approved" programs, and clearinghouses would be required "to tailor their practices . . . to satisfy each state's formulation of the standard of care in a negligence action. Such a result would destroy the Congressionally-mandated uniform system governing securities trading."[261] Similarly, transactional state law requirements may pose an obstacle to clearinghouses' "accomplishment of congressional objectives," while concurrent compliance with divergent securities transactions rules is clearly impossible.[262]

And what of discretionary actions effectively involving the exercise of business judgment within preapproved programs' parameters? Negligence should remain an inappropriate standard, as the Second Circuit has pointed out.[263] From an economic perspective, an SRO like a clearinghouse is an expert body, which needs *both* its discretion and the freedom to exercise it. Hence, to the market, the danger is not only that negligence analysis "would force a court to substitute its judgment for that of the experts" in an "after-the-fact litigation," but also that "such an intrusion would conflict with the Congressional scheme of exchange self-regulation," and most importantly, "increase market uncertainty."[264] In that case, both the court and the SEC, as expressed in its amicus brief, reaffirmed the value of procedural fairness and the finality of

259 The tortious interference with prospective economic advantage claim, however, survived the motion to dismiss. *Id.* at 397–99. The court observed that "[w]hether plaintiff can prove all the elements of a tortious interference claim is, of course, a different question, which will no doubt be explored in discovery." *Id.* at 398.

260 *See, e.g.*, Brawer v. Options Clearing Corp., 807 F.2d 297 (2d Cir. 1986); Capece v. Depository Tr. & Clearing Corp., No. 05-80498 CIV RYSKAMP, 2005 WL 4050118 (S.D. Fla. Oct. 11, 2005); Dexter v. Depository Tr. & Clearing Corp., 406 F. Supp. 2d 260, 261 (S.D.N.Y. 2005).

261 *Capece*, 2005 WL 4050118, at *9.

262 Nanopierce Techs., Inc. v. Depository Tr. & Clearing Corp., 168 P.3d 73, 76–77, 83 (Nev. 2007).

263 *Brawer*, 807 F.2d at 302 ("There are good reasons why a negligence standard has not been and should not be applied to SRO decisionmaking.").

264 *Id.* at 302–03.

clearinghouse decisions, and effectively refused to muddy the transparency of clearing operations by impromptu judicial quirks.[265] Instead, clearinghouses are expected to have internal procedural safeguards, such as various committees, which examine market circumstances and make appropriate adjustments ensuring fairness of operational decisions.[266]

By the same token, in cases where a party believes that a clearinghouse's action is arbitrary and capricious, the complaint may be more "properly addressed to the SEC, which oversees [clearing agency] activities."[267] The benefit of kicking some alleged instances of misbehavior back to the regulator is that it draws on the safety valves of Postulates I, II, and III. For instance, the SEC unquestionably would have better expertise in evaluating a rule and its application than generalist courts, the benefit expressly acknowledged by some judges.[268] In addition to this common advantage of administrative review, the SEC may prompt a culprit to reconsider the practices at issue ahead of unnecessary and wasteful litigation. Finally, in the clearinghouses case, the misfortunes of an aggrieved party may resonate with the members of a clearinghouse, which, because of the participatory corporate governance mechanisms embedded in Postulate III, may cause a direct change in a rule or its administration.

Consider third that the preeminence of congressional approval of the national clearing market and deference to the SEC and its mandate to implement C&S reforms necessarily bring into action the doctrine of federal preemption. This doctrine helps clearinghouses secure dismissal of lawsuits and cuts off many state law causes of action. Examples of such commonly brought state law causes of action vary from the abovementioned negligence claims, to challenges to the administration of clearinghouse programs or to the programs per se, misrepresentation, market manipulation, intentional interference with contractual relations, and many others. In most cases, various circuit courts, district courts, and state courts are in agreement on the subject of preemption.[269]

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265 *Id.* at 303.

266 *Id.* at 300–01 (reviewing OCC bylaws).

267 Olde Monmouth Stock Transfer Co. v. Depository Tr. & Clearing Corp., 485 F. Supp. 2d 387, 396 (S.D.N.Y. 2007).

268 *See, e.g.*, PennMont Sec. v. Frucher, 586 F.3d 242, 247 (3d Cir. 2009) (observing, generally, in respect to an exchange rule that the court "would be far better positioned to consider the propriety of the application of Rule 651 had PennMont given the SEC the opportunity to apply its expertise to this matter in the first place").

269 *See, e.g.*, Pet Quarters, Inc. v. Depository Tr. & Clearing Corp., 559 F.3d 772, 778, 782 (8th Cir. 2009) (affirming a district court decision dismissing the claims of market manipulation, illegal tying, conversion, and conspiracy, as "amount[ing] to direct, facial attacks on the operation of the Commission approved program," and misrepresentation claims

The underlying rationale may be simplified and expounded as follows: Imagine that a state court decides to side with a plaintiff and finds that a transaction performed under a clearinghouse loan program, officially designated the "Stock Borrow Program," is nothing but a sale. Such a finding certainly "would conflict directly with the Commission approved rules" on the Stock Borrow Program, as well as "with the Commission's control of the national securities clearing and settlement system and pose an obstacle to the congressional objectives in Section 17A."[270] Hence, preemption should follow naturally.

In this Article, I leave the pertinent discussions on the distinctions between conflict preemption and field preemption in C&S statutes for another day.[271] They are less important to this research than the actual results (i.e., the dismissals). As an aside, the research conducted for this Article found only one case where a clearinghouse, specifically, the OCC, was named as a defendant and where the court was somewhat hesitant to endorse preemption.[272] The fulcrum of that Ninth Circuit case, however, was not the statutory provisions on clearing per se, but section 9 of the Exchange Act—a security price manipulation provision. In the end, the court upheld the grant of summary judgment and found the state law claims meritless.[273]

"preempted because they attacked elements of that program"); Whistler Invs., Inc. v. Depository Tr. & Clearing Corp., 539 F.3d 1159, 1166–68 (9th Cir. 2008) (deciding on an assortment of misrepresentation, unfair trade practices, market manipulation, and other claims, and finding that all of them are preempted "under the doctrine of conflict preemption"); Capece v. Depository Tr. & Clearing Corp., No. 05-80498 CIV RYSKAMP, 2005 WL 4050118, at *8–9 (S.D. Fla. Oct. 11, 2005) (finding that "[p]ervasive Congressional regulation of the securities trading industry requires that this matter be heard in federal court. The same regulation also mandates dismissal of state law challenges to the operation of the securities market," and also reviewing "[t]he 'substantial federal interest' doctrine[, which] requires removal of a putative state law complaint when the resolution thereof requires inquiry into areas in which the federal government has a substantial and comprehensive interest," and finding that "any resolution of Plaintiffs' claim is dependent upon the scope and requirement of federal law"); Nanopierce Techs., Inc. v. Depository Tr. & Clearing Corp., 168 P.3d 73, 79–85 (Nev. 2007) (reviewing a complaint alleging various misrepresentation, unfair trade practices, market manipulation, conversion, intentional interference with contractual relations, and other claims; providing a comprehensive analysis of the preemption doctrine, including express and implied preemption, field preemption, and conflict preemption; and finding that the claims conflicted with the congressional regulatory scheme). These cases mainly challenged the Stock Borrow Program (SBP), created by DTCC subsidiaries to mitigate the risks of short-term fails to deliver. Complaints also alleged, inter alia, "that the naked short selling was facilitated by . . . defects in a [NSCC] program," *Whistler Invs.*, 539 F.3d at 1163, that NSCC and DTC "failed to monitor the SBP" properly, *Capece*, 2005 WL 4050118, at *3, or that the value of plaintiff's stock was diluted by such "loaning," *Pet Quarters*, 559 F.3d at 777–78.

270 *Pet Quarters*, 559 F.3d at 781–82.

271 *See, e.g.*, *Whistler Invs.*, 539 F.3d at 1165–67 (focusing on conflict preemption); *cf. Capece*, 2005 WL 4050118, at *6 (hinting at complete preemption).

272 Golden Nugget, Inc. v. Am. Stock Exch., Inc., 828 F.2d 586 (9th Cir. 1987).

273 *Id.* at 590–91 (noting that "[u]nder the circumstances, we are hesitant to affirm the district court on the basis that state common law would necessarily conflict with the federal

Another cognate doctrine in cases concerning SEC-approved rules and SROs is regulatory immunity. Recall from the discussion in Section III.B.1 that the early statutory reforms converted clearinghouses into SROs to whom the SEC delegated significant market oversight functions. By extension, an SRO may stand in the SEC's shoes as immune from suits so long as its conduct is within the ambit of its regulatory purposes, programs, and functions under federal securities law.[274]

Furthermore, following a program backed by a regulatory imprimatur, or even failing to comply with the program, does not easily lend itself to a successful private suit, nor does it imply the existence of a private right of action, particularly absent a showing of bad faith.[275] Think about the reality and economics of SRO operations and clearing. Clearinghouses need to exercise *discretion* in discharging some of their SEC-approved duties. Thus, reality dictates that in certain cases "the implication of a private cause of action could undermine the ability of [clearinghouses] to perform their functions."[276]

Finally, courts exhibited a profound understanding of C&S functions by being careful not to impose additional presumptive duties on a clearinghouse, a large entity with attractively deep pockets. Consider that the objectives of clearing and clearinghouses' duties to their members are (a) predetermined by their functions as economical and reliable conduits assuring safe exchange of assets among counterparties, and (b) carefully spelled out in the participant agreements and bylaws. This twofold arrangement calls for limited liability.

In some cases, clearing conduits perform only simple ministerial operations.[277] For instance, C&S facilities may act as disbursing agents

regulatory scheme," but upholding the district court's decision granting the defendants' motion for summary judgment).

274 Dexter v. Depository Tr. & Clearing Corp., 406 F. Supp. 2d 260, 262–64 (S.D.N.Y. 2005); *cf.* Platinum Partners Value Arbitrage Fund, LP v. Chi. Bd. Options Exch., 976 N.E.2d 415, 419 (Ill. App. Ct. 2012) (finding that the disclosure of "information about the price adjustment of a stock option to selected market participants before that information is made publicly available" did not serve a regulatory or governmental purpose and thus, "the doctrine of regulatory immunity [would] not apply").

275 *See, e.g.*, Brawer v. Options Clearing Corp., 807 F.2d 297, 299 (2d Cir. 1986) ("[W]e affirm and hold that a private cause of action against an exchange or a clearinghouse for failure to comply with one of its rules which requires an exercise of discretion . . . may be brought only if it is premised upon allegations of fraud or bad faith."); *In re* Adler, Coleman Clearing Corp., No. 95-08203 (JLG), 1998 WL 551972, at *27–30 (Bankr. S.D.N.Y. Aug. 24, 1998) (discussing similar supporting arguments and case law); *see also* Olde Monmouth Stock Transfer Co. v. Depository Tr. & Clearing Corp., 485 F. Supp. 2d 387, 396 (S.D.N.Y. 2007); *Capece*, 2005 WL 4050118, at *3, *6–8; *Dexter*, 406 F. Supp. 2d at 262–63.

276 *See, e.g.*, Brawer v. Options Clearing Corp., 633 F. Supp. 1254, 1261 (S.D.N.Y. 1986).

277 *See, e.g.*, *Dexter*, 406 F. Supp. 2d at 264 (referring to DTC's actions as "ministerial"); Smith Barney, Harris Upham & Co. v. Liechtensteinische Landesbank, 866 F. Supp. 114, 117

in bankruptcies or corporate reorganizations (i.e., they are not a party to the underlying agreements, distributions, or transactions).[278] In other cases, a clearinghouse may undertake to clear and settle transactions with participants' securities, but limit other obligations and, for instance, omit the duty to apprise the participants of reorganizations and exchanges of the securities.[279]

The standardized fees and low-cost nature of C&S services underlie and indeed presuppose their limited duties. Accordingly, clearing agencies normally are not compensated for extra risks that they would have incurred had they undertaken additional contractual obligations.[280] Inasmuch as they perform limited obligations, their potential liability should equally be limited.[281] Hence, this general approach to liability corresponds to the industry's objective of providing cost efficient C&S services.

4. Negative Decisions as Proof of Postulate IV

Out of the twenty-four decisions in the sample, only two were "against" clearinghouses.[282] Both confirm the foregoing "confluence of circumstances" and judicial noninterventionism (i.e., Postulate IV). In both cases, the clearinghouses were outside of the market-regulator

(S.D.N.Y. 1994) ("[T]he nature and object of the Agreement . . . is that DTC would provide transfer depository services of a ministerial nature to Smith Barney . . . .").

278 *See, e.g.*, Onco Inv. Co. v. Nw. Bank Minn., 222 F. App'x 100, 102 (3d Cir. 2007) ("DTC was not a party to the Senior Noteholder Agreement, however, and its responsibility under the Plan was limited to making distribution in accordance with the final, court-approved Plan, a task which it concededly performed.").

279 *See, e.g.*, Jackson Nat'l Life Ins. v. Gofen & Glossberg, Inc., 882 F. Supp. 713, 719 (N.D. Ill. 1995) (analyzing pertinent provisions of MSTC/MCC's Handbook and stating that "the rule merely apprises participants of the procedures MSTC follows when clients wish to act on reorganization activities," but "it does not require that MSTC give this notice").

280 *See, e.g.*, *Smith Barney*, 866 F. Supp. at 118 (observing "that the parties did not intend that DTC insure Smith Barney's deposits" and citing as evidence that DTC "sets fees irrespective of the value of the securities deposited").

281 Such cases often call for simple contractual analysis. *See, e.g.*, *id.* at 118 (analyzing DTC's contractual obligations and finding "there is not evidence upon which a jury could determine an absence of good faith on the part of DTC in carrying out its contractual duty"); Pompano-Windy City Partners, Ltd. v. Bear Stearns & Co., 794 F. Supp. 1265, 1290–91 (S.D.N.Y. 1992).

282 Chapdelaine Corp. Sec. & Co. v. Depository Tr. & Clearing Corp., No. 05 Civ. 10711(SAS), 2006 WL 2020950 (S.D.N.Y. July 13, 2006); Platinum Partners Value Arbitrage Fund, LP v. Chi. Bd. Options Exch., 976 N.E.2d 415 (Ill. App. Ct. 2012). The third seminegative one was Olde Monmouth Stock Transfer Co. v. Depository Tr. & Clearing Corp., 485 F. Supp. 2d 387, 397–99 (S.D.N.Y. 2007) (directing the parties to draft a discovery plan with respect to the claim for tortious interference with prospective economic advantage, but dismissing all other claims). The "outside the equilibrium," private nature of DTC's actions in this case, such as contacting plaintiff's customers, *id.* at 388–89, was similar to the key decisions discussed in this Section.

equilibrium. Namely, they transacted as private entities acting out of self-interest.

Their tactical decisions were not captured by the aforementioned corporate self-monitoring mechanisms. As participant-monitors did not have a specific interest in the outcome of the clearinghouses' actions in question, the existing risk-incentive backstops became irrelevant. Nor did the regulations touch upon those actions, since the actions at issue were only marginally related to the stability of the national C&S system.

In the first case, *Platinum Partners*, the decision of a clearinghouse was not within the purview of a preapproved program. In sum, the OCC and the CBOE adjusted a strike price of certain options and disclosed that decision *privately* to certain market participants prior to the *public* announcement of the adjustment. The court, as is common, first focused on the doctrine of regulatory immunity and the agencies' duties as SROs.[283] After that junction, *Platinum Partners* and the typical "positive" decisions diverge.

The *Platinum Partners* court demarcated two separate actions, including (1) the price adjustment, which "itself may have been a regulatory decision, [and (2)] the manner in which it was disclosed—privately and prematurely— . . . [which] was not."[284] The private manner of disclosure was unrelated to any identified regulatory purposes and benefited the OCC and the CBOE as *private* entities "acting in their private capacity and for their own corporate benefit."[285]

The second case also addressed the manner of clearinghouse operations and additional contractual issues. In short, the plaintiff attempted to license its software to the DTCC. In the course of the negotiations, the parties signed a nondisclosure agreement and discussed certain functional specifications of the software. When the negotiations broke down, the DTCC "announced its plans to develop its own software system," allegedly "caus[ing] potential . . . licensees to cease negotiations with [the plaintiff]," which precipitated the lawsuit.[286]

The plaintiff brought antitrust claims, among others. As discussed in Section III.C, the DTCC's subsidiaries are and were for a long time a de facto monopoly. The defendant asseverated that, being a clearing agency, it was merely "a utility . . . provid[ing] automated centralized clearing and settlement services," while the plaintiff was "an interdealer broker and software developer."[287] At first glance, such different businesses did not share a "relevant market" that could be monopolized

283 *Platinum Partners*, 976 N.E.2d at 419 (reversing the trial court decision, which was "based on defendants' conduct as self-regulatory organizations" and regulatory immunity).

284 *Id.* at 422.

285 *Id.*

286 Chapdelaine Corp. Sec., 2006 WL 2020950, at *2.

287 *Id.* at *5.

by the DTCC. The court, however, was hesitant to grant DTCC's motion to dismiss without a fact-intensive inquiry.[288]

As a final remark, there could be other auxiliary reasons for the court's decision. Structurally, the odds were stacked against a small licensor whose product possibly was misappropriated by a monopoly, enabling the latter to offer the same service within a larger package. Perhaps that was one of the additional reasons for the judicial reluctance, which helps explain why this case stands in contrast to *Olde Monmouth*, another Southern District of New York decision, where the court sided with the DTC, a monopoly, finding that the DTC and a transfer agent operated in different markets.[289]

5. Conclusion

One would not want to substitute normative premises for positive implications of the regulator-market-court arrangement discussed in this Section. Indeed, courts are not a harmonious and single-minded body. Nor are the facts in the disputes discussed all alike. However, this does not refute the suggestion that a de facto cooperative equilibrium involving courts, regulators, and clearinghouses existed for almost four decades. The sample cases demonstrate that even though that cooperation has been based on such positive premises as federal preemption or the regulatory approval of clearinghouse rules, Postulate IV does seem to exist and does reinforce the linear market-regulator interaction.

V. THE TRADITIONAL MODEL AND POSTCRISIS REGULATIONS

A. *Introduction*

Post–Dodd-Frank regulations comply with none of the characteristics of the model described in this Article. Recall that the *raison d'être* of the reforms is not that clearinghouses were or are in dire straits or that the SEC failed to properly supervise the C&S businesses. Instead, the reforms resulted from across-the-board regulatory changes and the perceived general failure of sector-specific regulators during the

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288 *Id.* at *3, *5 (finding that the "stated market is sufficiently plausible to withstand the motion to dismiss").

289 *See* Olde Monmouth Stock Transfer Co. v. Depository Tr. & Clearing Corp., 485 F. Supp. 2d 387, 397–99 (S.D.N.Y. 2007). Recall, however, that the motion to dismiss the claim for tortious interference with prospective economic advantage was denied. *Id.*

crisis, which originated in other sectors of the financial industry.[290] This Part examines how—at the risk of upsetting the preexisting balance—the SEC is bending its policies in response to post–Dodd-Frank coordination and whether the new rules may disturb the key postulates of the traditional arrangement (i.e., the cooperative market-regulator interaction and sector-specific expert decision making).

B. *Postulates I, II, and III: Dodd-Frank and Derivatives Clearinghouses*

The first issue to review is the expansion of the SEC's jurisdiction over additional "supervisees." Currently, seven entities are active registered clearing agencies. Four of them have derivatives, futures, and swaps clearing businesses and are dually registered with the SEC and the CFTC. Some of the entities have been added due to their clearing of security-based swaps pursuant to the "Deemed Registered Provision" under Title VII of Dodd-Frank.[291] The primary supervisory agency for those derivatives clearinghouses is often the CFTC, although the SEC also has a say in their regulation.[292]

The corporate governance structures of the newly added clearinghouses and of the *traditional* clearinghouses are divaricate. Namely, the antitrust and monitoring backstops, as well as the market organization, cumulatively comprising Postulate III, differ. Historically, regulators were more concerned with fragmentation in the derivatives clearing market, particularly futures C&S, and the lack of competition, than in the case of the securities clearing industry.[293] Such issues as clearing fragmentation, vertical integration, and inadequate interexchange clearing resurfaced every so often in various studies and

290 *See* discussion *supra* Part I. In contrast, "[p]ast reforms tended, overall, to be roughly proportional to precipitating events." *See, e.g.*, Cunningham & Zaring, *supra* note 1, at 72.

291 Amendment to Rule Filing Requirements for Dually-Registered Clearing Agencies, Exchange Act Release No. 69284, 78 Fed. Reg. 21046-01, 21047–48 (Apr. 3, 2013) (to be codified at 17 C.F.R. pts. 240 and 249).

292 *Id.* at 21048; *see also* 15 U.S.C. §§ 78c-3, 78q-1 (2012).

293 *See, e.g.*, Wolkoff & Werner, *supra* note 15, at 345, 355, 359 (discussing the policy evolution from the 1970s through the 1999 reforms). Today, there is no central clearing venue for futures. Instead, the industry operates within vertical silos. *Id.* at 374–75.

public statements, including the post-1987 market crash studies,[294] as well as in more recent Justice Department letters.[295]

That fragmentation was deeper than in securities markets and persisted side by side with increased industry consolidation. By the mid-1990s, most trading in futures occurred and was settled through Chicago's markets.[296] Today, within the CME Group, there is CME Clearing, a registered clearing agency and derivatives clearing organization registered with both the CFTC and the SEC under Dodd-Frank.[297] CME Clearing clears transactions effected on the CBOT, CME, COMEX, and NYMEX exchanges, as well as OTC transactions.[298] Another market is the ICE, which after a series of acquisitions—including a spectacular foray on NYSE Euronext in 2013[299]—also became one of the largest exchanges. It is the second-largest futures market in the world and is also involved in credit default swaps (CDS) clearing.[300] The Exchange has its own clearinghouses, some of which are dually registered with both commissions.[301]

Both CME and ICE clearinghouses provide services for multiple derivatives products. Obviously, both entities fall under the definition of

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294 GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 11, 65 n.4 (mentioning that the Chicago markets dominate clearing and that contracts are not fungible between exchanges); *see also* Wolkoff & Werner, *supra* note 15, at 313–14, 374–75 (discussing the dominant position of CME in futures trading and the vertical integration model of clearing, and observing that in contrast to the securities market, regulators were unable to develop market competition in the futures industry).

295 In a 2008 letter to the Treasury, the Justice Department emphasized "that the control exercised by futures exchanges over clearing services . . . has made it difficult for exchanges to enter and compete in the trading of financial futures contracts." Will Acworth, *Justice Department Urges Treasury to Examine Clearing Arrangements in U.S. Futures Industry*, FUTURES INDUS., Mar.–Apr. 2008, at 42, http://www.futuresindustry.org/downloads/Mar-Apr_Wash_Watch.pdf.

296 GAO, PAYMENTS, CLEARANCE, AND SETTLEMENT, *supra* note 64, at 68–75; GAO, CLEARANCE AND SETTLEMENT REFORM, *supra* note 67, at 11.

297 Amendment to Rule Filing Requirements for Dually-Registered Clearing Agencies, Exchange Act Release No. 69284, 78 Fed. Reg. 21046-01, 21047 n.20 (Apr. 3, 2013) (to be codified at 17 C.F.R. pts. 240 and 249).

298 *See, e.g.*, CME GRP., SUMMARY OF REQUIREMENTS FOR CME, CBOT, NYMEX AND COMEX CLEARING MEMBERSHIP AND OTC DERIVATIVES CLEARING MEMBERSHIP 1 (2016), http://www.cmegroup.com/company/membership/files/Summary-of-CMEG-Clearing-Membership-Requirements.pdf.

299 *ICE Buys NYSE-Euronext: The End of the Street*, ECONOMIST (Nov. 16, 2013), http://www.economist.com/news/finance-and-economics/21589913-improbable-takeover-highlights-uncertain-future-share-trading-end.

300 *Overview*, INTERCONTINENTAL EXCH. (2016), https://www.intercontinentalexchange.com/publicdocs/ICE_at_a_glance.pdf; *see also* Futures Industry Association, *Largest Derivatives Exchanges Worldwide in 2014, by Number of Contracts Traded (in Millions)*, STATISTA, http://www.statista.com/statistics/272832/largest-international-futures-exchanges-by-number-of-contracts-traded (last visited Apr. 17, 2016).

301 *See Overview*, *supra* note 300.

"systemically important" FMUs under Title VIII of Dodd-Frank.[302] Monitoring these entities is bound to create new challenges for the Commission, which is less accustomed to dealing with the new supervisees because of their different businesses *and* industry organization.

The second related concern is the a priori disparate *corporate governance* structure and the lack of customary monitoring backstops characteristic of the *traditional* securities clearinghouses. In a nutshell, CME Clearing is a division of CME Inc., which "is a wholly-owned subsidiary of CME Group."[303] "The Board of Directors of CME Inc. is comprised of the same individuals as the Board of Directors [of] CME Group . . . ."[304] Although international standards would require governance arrangements to recognize broad interests of various stakeholders, as the Group acknowledges, CME also explicitly underscores that "the Board represents the shareholders' interests."[305] There are, of course, procedural safeguards, such as the presence of a majority of independent directors on the Board, an independent Nominating Committee, a separate Clearing House Risk Committee in charge of financial surveillance, and member monitoring and disciplinary policies, among other protections.[306] Nevertheless, the corporate ownership and governance structure differs from the DTCC's broader stakeholder approach.

The same applies to, for example, ICE Clear Credit (ICECC), a clearinghouse registered with the SEC under Dodd-Frank. ICECC is a subsidiary of Intercontinental Exchange, Inc. Just like in the case of CME, several independent directors (at least six out of eleven) on ICECC's Board of Managers are intended to serve as a corporate safety valve.[307] Similar to CME, the layout of the Board implies a substantial representation of the parent exchange. The Board, of course, is advised by the Risk Committee, Advisory Committee, and Risk Management Subcommittee, tasked with risk-related assessments and recommendations, and member eligibility standards, among other responsibilities.[308] Even though all risk committees include clearing participants, which "is necessary because of the risk mutualization

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302 *Designated Financial Market Utilities*, *supra* note 203.

303 *See, e.g.*, CME GRP., CME CLEARING: PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES DISCLOSURE 2, 18 (2015), http://www.cmegroup.com/clearing/risk-management/files/cme-clearing-principles-for-financial-market-infrastructures-disclosure.pdf.

304 *Id.* at 18.

305 *Id.* at 20.

306 *See id.* at 22–24, 30–31.

307 ICE CLEAR CREDIT, REGULATION AND GOVERNANCE: FACT SHEET 2 (2016), https://www.theice.com/publicdocs/clear_credit/ICE_Clear_Credit_Regulation_and_Governance.pdf.

308 *Id.* at 3.

function of a clearing house—non-defaulting members are responsible for covering losses in the event of a default of another clearing member"[309]—as well as broader risk monitoring concerns, such committees issue mainly *advisory* opinions. The Board is not obligated to accept their proposals.[310] Once again, similar to the CME's management, the ICE clearinghouse ownership and governance structure may not allow a similarly strong representation of the participants and other stakeholders' interests as the ownership and governance mechanisms of the DTCC or the OCC.

In theory, the SEC will need to recalibrate its traditional approach (i.e., Postulates I and II) in order to properly evaluate such different entities. Their shareholders may not have the same monitoring incentives, while other stakeholders do not have the same oversight opportunities as those enjoyed by the "traditional" clearinghouses' stakeholders.[311] In other words, the recalibration should reflect the fact that Postulate III of the market-regulator interaction must be different—or even weaker.

The Commission has exhibited a somewhat surprising eagerness to review the proposed rules of such new entities and thereby has committed to monitoring them more closely. In the rule filing requirements, the Commission suggested, in pertinent part, that:

> The Exchange Act imposes upon the Commission an independent statutory responsibility to oversee the operations of Registered Clearing Agencies as a whole, and not solely in regard to specific products. . . . Accordingly, the Commission believes that its continued review of rule filings that primarily affect a Dually-Registered Clearing Agency's operations involving futures that are not securities futures, swaps that are not securities swaps or mixed swaps . . . and other non-securities products is a *necessary and appropriate part of the Commission's statutory mandate.*[312]

These peremptory statements are problematic in several respects. Even though the need to effect adequate supervision indeed may dictate placing the new businesses in context, it also leads to wasting public

309 *Id.* at 2.

310 *Id.* at 3; *see also* ICE CLEAR CREDIT, CLEARING RULES 52, 62 (2016), https://www.theice.com/publicdocs/clear_credit/ICE_Clear_Credit_Rules.pdf (discussing rules 501 and 509).

311 *See, e.g.*, Yadav & Turing, *supra* note 10, at 12–13 (discussing the pros and cons of different ownership structures of CME and ICE Clearing).

312 Amendment to Rule Filing Requirements for Dually-Registered Clearing Agencies, Exchange Act Release No. 69284, 78 Fed. Reg. 21046-01, 21053 (Apr. 3, 2013) (to be codified at 17 C.F.R. pts. 240 and 249) (emphasis added).

resources, acquiring duplicate supervisory expertise,[313] and to pertinent coordinating with the CFTC. The accompanying risk of *collectivism* may manifest itself through jurisdictional uncertainty or by triggering group dynamics and coalition building within the newly overcoordinated regulatory network. It may also occasion ex post regulatory turf wars among regulators with inherently different philosophies and expertise.[314]

The Commission certainly deserves credit for being demonstrably cautious about this issue in other rules. In a 2014 release proposing a new rule related to standards for systemically important clearing agencies, the Commission correctly sought to cede its authority to the CFTC where, for instance, a CCP clears security-based swaps and the CFTC is its primary supervisory agency.[315] The proposed rule is a step in the right anticollectivist direction.

Yet the release conflicts with the statements that the SEC needs to evaluate the derivatives market clearing and place it "in proper context."[316] Hence, the "totality" of the statements demonstrates inadequate jurisdictional clarity. Self-evidently, such ambiguities may ricochet, bring about uncertainty in industry practices, and increase derivatives clearinghouses' compliance costs.

C. *Blunders and Regressing Toward the Mean*

The problem of increased compliance costs and uncertainty is bidirectional: not only will the derivatives clearinghouses be affected by the SEC's actions, but also the new recalibration may impact the traditional clearing supervisees (i.e., securities clearinghouses) in unpredictable ways. The major germane risk is the superfluous spillover of the rules designed for one set of entities into the regulation of substantially different institutions.

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313 The SEC has already spent disproportionate resources on developing some marginal Dodd-Frank rules. For instance, security-based swaps were an infinitesimal part of swaps as an asset class. *See* Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n, Speech at the 15th Annual A.A. Sommer Jr. Lecture on Corporate, Securities and Financial Law: The Securities and Exchange Commission—The Next 80 Years (Oct. 16, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543190122#.VN7GRPnF_iU. A far-reaching commitment to future monitoring of "nontraditional" clearinghouses within the primary jurisdiction of the CFTC may further overstretch the scarce resources of the SEC.

314 *See* discussion *supra* Part II.

315 *See* Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29516 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240).

316 Amendment to Rule Filing Requirements for Dually-Registered Clearing Agencies, 78 Fed. Reg. at 21053.

An example of this spillover is what this Article refers to as the "regression toward the regulatory mean." This regression may be both natural and intuitive. Specifically, it is simpler for a regulatory body to apply the same set of harmonized rules to all entities within a regulated industry. More individualized approaches consume more public resources and may cause friction among regulators with overlapping jurisdictions. In addition, due to the associated economies of scale, the more entities an agency regulates, the easier it is to apply a single set of average regulations.

Another possible cause of the regression is the lack of ex ante market input. Perhaps for the first time in the history of the U.S. C&S industry, a statute has mandatorily extended centralized clearing and the SEC's authority to new financial instruments *and* additional entities, absent meaningful industry experiments. There were some early industry initiatives, such as new trade repositories,[317] but swap clearing centralization does not appear to be principally market driven.

In one of the major articles on clearinghouses, Mark Roe has aptly described how the regulators seized on the idea of clearing centralization and then suggested and advertised it to the financial markets.[318] Similarly, there seemed to be no consensus on the best way to approach swaps clearing. Professor Griffith, for instance, discussed meaningful alternative solutions proposed by industry groups and academics.[319] Without market-supplied templates, the regulators may be enticed to borrow from one another. Regulatory averages and accompanying harmonization are thus a natural outcome. On the policy side, Dodd-Frank overcoordination, and the accompanying risk of collectivism, spur this imitation.

For example, under Title VIII, clearing agencies that are systemically important FMUs[320] are subject to enhanced supervision by not only the SEC, but also by other regulators, such as the Board of Governors of the Federal Reserve System, with whom the SEC must consult on certain aspects of rulemaking.[321] The CFTC and the SEC logically cannot apply completely divergent requirements to FMUs.[322]

317 One of the first repositories was created by DTCC. Today, the industry is developing global repositories. *See, e.g.*, *About DTCC*, DEPOSITORY TR. & CLEARING CORP., http://www.dtcc.com/about (follow "Our Capabilities" hyperlink) (last visited Apr. 17, 2016); *see also* Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29511–12 (discussing the "deemed registered" provision and pre-Dodd-Frank agencies clearing swaps).

318 Roe, *supra* note 54, at 1655–56.

319 Griffith, *supra* note 12, at 1359–64.

320 12 U.S.C. §§ 5462(4), (6) (2012); Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29512 nn.26–27.

321 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29512 nn.26–27 (discussing the coordination mechanisms of sections 805–807, 809, and 813 of the "Clearing Supervision Act," Payment, Clearing, and Settlement Supervision Act of 2010, Pub. L. No. 111-203, tit. VIII, secs.

Today, the final and proposed rules of both commissions in part are tailored to the specifics of their respective markets.[323] Yet, in part they also already apply "average" rules across various sectors. One example of the self-evident outgrowth of any generic rulemaking is the danger that an expert regulator, such as the SEC, may occasionally blunder and succumb to a "view [that] derives principally from the default management practices of derivatives CCPs . . . . [and] is in marked contrast to the U.S. cash markets."[324]

Consider another example where the new SEC release on covered clearing agencies fails to account for the specifics of the U.S. C&S industry. In sum, recall that there are only a handful of sole providers of C&S services in the securities and options markets. Hence, the competition is, as the SEC acknowledges in other parts of the release, nonexistent.[325] Against this backdrop, such standard and average requirements as, for instance, establishing "orderly wind-down" plans may appear questionable—a "wind-down [plan] is not necessarily a workable option for critical [and monopolistic] market infrastructure providers" in the United States.[326]

Finally, averages may create unnecessary challenges for the traditional clearing agencies. A case in point is the capital and funding requirements and the possible related modifications of corporate ownership. This, for instance, puzzled the OCC, which pointed out the difficulties of "raising equity capital through the issuance of common stock" due to its peculiar corporate ownership structure and called for more regulatory flexibility in this respect.[327]

805–807, 809, 813, 124. Stat. 1376, 1802 (codified as amended at 12 U.S.C. §§5464–5466, 5468, 5472 (2012))); *see also* 12 U.S.C. § 5464. The Clearing Supervision Act further "provides that the Commission, considering relevant international standards and existing prudential requirements, may prescribe regulations that set risk management standards," and must consult with the Board and the FSOC. Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66222 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

322 *See, e.g.*, Clearing Agency Standards, 77 Fed. Reg. at 66221–22.

323 *See generally* Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29588–89 (discussing the securities-specific provisions and distinctions).

324 Letter from Larry E. Thompson, *supra* note 12, at 8 (commenting on the proposed participant default rules and procedures); *see also* Clearing Agency Standards, 77 Fed. Reg. at 66233 (discussing DTCC's comments on the absence of cost-benefit analysis for financial resources requirement); *id.* at 66233 n.151 (discussing OCC's comments on the greater challenges associated with risk management tasks in options compared to some security-based swaps).

325 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29587–90.

326 *See, e.g.*, Letter from Larry E. Thompson, *supra* note 12, at 6 (commenting on wind down and recovery planning); *see also id.* at 7–8 (commenting on depository rules).

327 *See, e.g.*, 2014 OCC Letter, *supra* note 24, at 13–14 (commenting on the OCC's equity structure, revenues, and funding strategies).

D. *Logical Inconsistencies*

The final issue is the impending paradigmatic changes in the overall philosophy of the Commission (i.e., Postulates I and II). The SEC apparently struggles to reconcile the old, more flexible approach with the new, more rule-based philosophy of other regulators and of Dodd-Frank. The initial postcrisis rule established "*minimum* requirements for registered clearing agency risk management practices and operations with due consideration given to equivalent standards of other regulators in the United States and to international standards."[328] The rule applied to the clearing agencies registered with the SEC.[329]

The general tone of these 2012 standards paid homage to the SEC's traditional principles-based approach. The Commission exhibited some deference to the discretion and expertise of clearinghouses, using words like "flexibility" as frequent descriptive terms explaining the provisions' *raison d'être*.[330]

It seems the SEC was also striving to strike an appropriate balance between the new requirements, prescriptive rigidity, and principles-based traditions. For instance, it acknowledged that some risk management and other standards require business judgment, particularly important in light of ever-changing market conditions.[331] The Commission also seemed responsive to the comments and, in case of a disagreement, provided more or less cogent arguments in support of its position.[332] It also promised a continuous open dialogue should questions arise due to "the dynamic nature of clearing agency risk management practices [and] changing market practices."[333]

The Commission, in keeping with its tradition, converted many *preexisting* business practices into minimum standards and

328 Clearing Agency Standards, 77 Fed. Reg. at 66224 (emphasis added) (footnote omitted); *see also id.* at 66229 (summarizing the content of the rule).

329 *Id.* at 66258.

330 Terms like "flexibility" and "flexible" are found thirty-four times in the text of the 2012 Release, and in most cases they refer to the clearinghouses' discretion. For instance, with respect to credit exposure management, the SEC stated that it "believes that a less prescriptive and more flexible rule sets a more appropriate baseline standard." *Id.* at 66231; *see also id.* at 66231–33, 66235, 66242–43, 66247 (generally underscoring the value of clearinghouses' expertise, regulatory flexibility, and the necessity to enable CCPs to determine the most effective approaches to mitigating various risks).

331 *See, e.g.*, *id.* at 66224–25 (taking into account implementation requests); *id.* at 66229–30 (addressing definitional concerns involving normal market conditions, participant family, and others); *id.* at 66237–38 (conceding on some model validation requirements); *id.* at 66249–50 (mentioning the discretion needed in establishing tailored settlement bank practice rules).

332 *See, e.g.*, *id.* at 66234–35 (citing research on CDS and standards affording appropriate flexibility); *id.* at 66240–43 (discussing the access, net capital restrictions, and other rules).

333 *Id.* at 66226.

benchmarks.[334] One example is the standards with respect to measurement and management of credit exposure, margin requirements, and financial resources. The standards are described as "*targets* for clearing agencies to meet without prescribing a particular method."[335] Similarly, in line with the longstanding regulatory trend of promoting existing best practices through codification, the SEC underscored the "commonly accepted [margining] practice as the minimum benchmark for measuring credit exposures and setting margin requirements."[336] By extension, CCPs are free to implement more conservative standards.[337]

The Commission even admitted that in certain areas, such as risk management, "a less prescriptive approach can help promote efficient practices and encourage regulated entities to consider how to manage their regulatory obligations and risk management practices in a way that complies with Commission rules while accounting for the particular characteristics of their business."[338] Even though clearing agencies were not entirely supportive of the rule, they acknowledged the SEC's efforts to preserve this principles-based mindset.[339]

This philosophy recently suffered a setback. A couple of years after the systemically important FMUs had been designated and the International Organization of Securities Commissions (IOSCO) came up with the new standards,[340] the SEC's tone somewhat sharpened and the discretion afforded to systemically important clearinghouses was further curtailed in some areas.[341] The resulting logical conundrum the SEC currently faces is evident, as is the potentially profound and ill-explained shift in its traditional philosophy *and* the manifest and almost

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334 *See, e.g.*, *id.* at 66226–28, 66230 (establishing risk management targets "without prescribing a particular method"); *id.* at 66231 (establishing a baseline standard and underscoring individual risk characteristics of CCPs); *id.* at 66232 (underscoring the value of flexibility in initial margin setting policies); *id.* at 66253–54 (mentioning the importance of collaboration between regulators and the ongoing efforts in some industry programs such as dematerialization); *id.* at 66272–73 (observing the consistency of the rule with industry practices and their codification).

335 *Id.* at 66230 (emphasis added).

336 *Id.* at 66226.

337 *Id.* at 66226–27.

338 *Id.* at 66226.

339 *See* discussion *infra* Section V.F.

340 *See, e.g.*, CPSS-IOSCO, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES, *supra* note 12; *see also* discussion *supra* Section II.A.

341 *See* Standards for Covered Clearing Agencies, Exchange Act Release No. 71699, 79 Fed. Reg. 29508-01, 29577 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240) (referring to the rules' consistency with Dodd-Frank and international standards as a justification for enhanced regulatory supervision).

axiomatic acceptance of the need for harmonization and coordination.[342]

In a nutshell, in 2014, the Commission proposed amending Rule 17Ad-22 to enhance mandatory requirements for general organization, financial risk management, default management, collateral, access, efficiency, transparency, operations, and governance of clearinghouses. The proposed rule places greater emphasis on more specific provisions, including, inter alia, reporting, auditing, stress testing, and statistical modeling.[343]

The proposed requirements are designed specifically for "covered" clearinghouses. This category generally includes clearing agencies designated as systemically important, unless their primary regulator is the CFTC.[344] Technically, all major *traditional* clearinghouses are now "covered."[345] The list also includes complex risk profile agencies providing CCP services for swaps.

The proposed rule, although still acknowledging the value of clearinghouse discretion, imposes more prescriptive standards.[346] The proffered explanations for the new rules and greater specificity abound. They vary from the traditional rationale of providing an impetus to certain business practices, to the need for "policies and procedures more closely tailored to the risks that are posed by covered clearing agencies, which the Commission preliminarily identified as appropriate in connection with its experience in supervising registered clearing agencies."[347] What is left unexplained, however, is which existing and serious clearing inefficiencies per se called for these new regulations.

It is thus understandable that the SEC struggles to fit the rule into the new context (i.e., greater prescriptiveness, policy harmonization, and coordination) while continuing to underscore the need for some flexibility. For instance, liquidity considerations were always part of

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342 On the plus side, the SEC seems to view the post–Dodd-Frank rules as a global market signaling device, unavoidable considering the international and domestic regulatory pressures and the cross-border scope of clearinghouse businesses. *See, e.g.*, Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66273 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240) ("[T]he Commission's adoption of Rule 17Ad-22 will lead to greater confidence, both domestically and internationally, in the resiliency of clearing agencies . . . .").

343 *See, e.g.*, Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29518 (providing an overview of the rules and proposed rules).

344 *Id.* at 29514–16 (describing the types of covered agencies, such as designated clearing agencies (i.e., systemically important FMUs for which the Commission is the supervisory agency), complex risk profile clearing agencies, and others).

345 *Id.* at 29515–16 ("For instance, because DTC, FICC, NSCC, and OCC are registered clearing agencies . . . , they would be covered clearing agencies under [the] proposed Rule . . . .").

346 *Id.* at 29588–89 (discussing the differences between the SEC's proposals, on the one hand, and the CFTC's and the Fed's rules, on the other).

347 *Id.* at 29515.

C&S regulatory standards. The new rule makes them more specific and, inter alia, adds "qualifying liquid resources" and at least annual testing with liquidity providers.[348] However, the Commission highlights, as it has in the past, the value of flexibility in using funding arrangements.[349] Similarly, it did not invent the testing requirements—comparable tests are "performed currently by certain registered clearing agencies but are subject to variation due, in part, to the absence of a regulatory requirement."[350] The SEC thus attempts, on the one hand, to adhere to the same market impetus-reform pattern and principles-based philosophy and, on the other hand, to promote more prescriptive and more coordinated policies.

Unfortunately, the Commission seems to flounder in its explanations of the underlying rationale for modifying the rules. For example, the SEC constantly references its regulatory experience, the value of which is weakened by concurrent countervailing references to the *new* international standards, and it accepts as a given the alleged "benefits that would accrue through maintaining consistency with regulations adopted by the Board and the CFTC."[351] Without additional research, this reasoning may seem unconvincing in light of the arguments against excessive regulatory uniformity and coordination discussed in Part II.[352]

Another example of the SEC's arguments that also appear somewhat unpersuasive concerns the dangers of "ambiguity," discussed in the section of the 2014 Release devoted to examining the value of discretion. Even disregarding the fact that, when referring to "[r]ecent academic research," the 2014 Release briefly cites a 1989 paper by Gilboa and Schmeidler,[353] a seminal theoretical paper per se, a more recent and more substantively relevant reference is questionable. The SEC relies on Easley and O'Hara's model, whose application is primarily relevant to the differences in the level of specificity of *exchange rules* and their pertinent listing and clearing standards, and the effect of such

348 *See id.* at 29531, 29534, 29569.

349 *Id.* at 29532; *see also id.* at 29534 ("Clearing agencies should have the *flexibility* to use stress scenarios that are appropriately calibrated to the markets in which they operate." (emphasis added)).

350 *Id.* at 29534 ("The Commission preliminarily anticipates the effect of the proposed rule will be to require the development of more uniform liquidity testing practices by covered clearing agencies, and has accordingly proposed to allow covered clearing agencies to assess the practicability of such testing to provide them with reasonable flexibility to design the tests to suit the circumstances of the covered clearing agency and its particular liquidity arrangements."); *see also id.* at 29588 (expanding the definition of qualifying liquid resources).

351 *Id.* at 29577.

352 *See* discussion *supra* notes 40–42 and accompanying text.

353 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29587 n.655 (citing Itzhak Gilboa & David Schmeidler, *Maxmin Expected Utility with Non-Unique Prior*, 18 J. MATHEMATICAL ECON. 141 (1989)).

specificity on ambiguity averse investors and traders.[354] The model does not suggest that U.S. regulators must step in to bolster specificity in the rules of all clearinghouses, particularly the *traditional* clearinghouses, but only that traders may gravitate toward exchanges with less ambiguous rules and that microstructure may increase participation by firms and issuers.[355]

There is no evidence that U.S. C&S rules suffered from the maladies of ambiguity as reflected, for instance, in the unmatched cost efficiency of the clearing industry. A more correct approach, therefore, would be to conduct separate studies to examine the effect of specificity in *C&S rules*.

Other somewhat inchoate arguments refer to the 2008 financial crisis. A good example, again, is the more specific rules on testing the sufficiency of financial resources, estimation of credit and liquidity exposures, and rules on pertinent analyses. A supporting point is the SEC's supervisory experience, which convinced the Commission

> that certain, but not all, covered clearing agencies adjusted their stress testing scenarios following the 2008 financial crisis to incorporate larger debt, equity, and credit market shocks similar to those experienced during the crisis. Accordingly, the Commission preliminarily believes that specific policies and procedures contemplating actions to be taken by all covered clearing agencies in such circumstances are necessary to ensure the safe functioning of the covered clearing agencies.[356]

Consider also, however, that, for instance, the DTCC's subsidiaries performed remarkably well despite significant market volatility and trade volume during the crisis.[357] Similarly, the "OCC never needed help during the financial crisis,"[358] and has already been working for at least two years on improving its risk management capabilities.[359]

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354 *Id.* at 29587 n.657 (citing David Easley & Maureen O'Hara, *Microstructure and Ambiguity*, 65 J. FIN. 1817 (2010)).

355 *See* David Easley & Maureen O'Hara, *Microstructure and Ambiguity*, 65 J. FIN. 1817 (2010).

356 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29527.

357 *See, e.g.*, DEPOSITORY TR. & CLEARING CORP., ANNUAL REPORT 2008, at 29–31 (2009), http://www.dtcc.com/~/media/Files/Downloads/About/Annual-Reports/2008_report.pdf.

358 Nina Mehta, *Options Clearinghouse Wants Access to Fed's Discount Window*, BLOOMBERG (June 23, 2010, 2:25 PM), http://www.bloomberg.com/news/2010-06-23/options-clearinghouse-lobbies-for-access-to-fed-funding-during-emergencies.html (noting also that, although it did not experience problems during the crisis, OCC sought "financing just in case a future crisis causes a shortfall").

359 *See, e.g.*, Craig Donohue, Exec. Chairman, Options Clearing Corp., Speech at the Risk USA Conference: Increasing the Resiliency of Central Counterparties and the Transformation of Clearing (Oct. 21, 2014), http://www.optionsclearing.com/about/newsroom/occ-views/2014/10_30.jsp.

Admittedly, the very fact that the traditional agencies did not even raise serious objections to this new provision implies that they already had done their homework and had not expected to incur substantial future compliance costs in this area.[360] Nevertheless, as the SEC itself acknowledges, some new requirements would "impose additional costs" on the agencies.[361] Hence, the primary concern here is that the SEC's explanation of the need for a formal rule, and the preliminary assessment of the costs, seem deficient.

It is, of course, understandable why some regulators may tend to invoke a political default formula (i.e., "let us blame the crisis") that is in vogue in the postrecession era. At the same time, a deeper reason for the regulatory changes could be that a sector-specific regulator, such the SEC, was acting under pressure from fellow regulators, triggered by the post–Dodd-Frank designations of clearing agencies as systemically important. In taking into consideration the philosophies of other agencies, such smaller sector-specific regulator may become more conformist and regress to the "regulatory mean." As there are reasons to caution against excessive, extraneously imposed, uniformity in certain risk management practices,[362] these issues ultimately need to be addressed by the Commission on a case-by-case basis.

It is also unclear why the SEC, in explicating the shift toward more prescriptive regulations, emphasizes that the covered clearinghouses are systemically important and "may transmit financial shocks," or that competition is limited and barriers to entry are high.[363] Indeed, they were so five, ten, and, to some extent, even thirty years ago. Market consolidation, for instance, is almost a rule of thumb in clearing. Have the repeated references to systemic importance become something of a fad echoing Dodd-Frank and international standards?

Similarly, somewhat baffling is the concern that, despite reputational repercussions and market monitoring, "clearing agencies' incentives for sound risk management may be tempered by pressures to reduce costs and maximize profits that are distinct from the public interest goals," the moral hazard problem, or incentive misalignments.[364] First, as discussed in Part III, that is why the

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360 *See, e.g.*, 2014 OCC Letter, *supra* note 24, at 9; Letter from Larry E. Thompson, *supra* note 12, at Annex 1.

361 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29597.

362 Channeling industry standards has been criticized as part of the "destructive coordination" of regulations, resulting in "the uniform application of a risk measure that presumes independence and randomness." Whitehead, *Destructive Coordination*, *supra* note 12, at 346. In light of the new rules, the risks of coordination in the C&S risk management and stress-testing requirements may be elevated to a more prominent risk in the future.

363 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29587, 29576, 29578–79.

364 *Id.* at 29576.

traditional clearing agencies have a more open, multistakeholder corporate governance structure. Second, in terms of revenue maximization, the DTCC described itself as "a user-owned cooperative," operating on an at-cost basis,[365] while the OCC had refund and fee discount policies.[366]

Another relevant example deals with the discretion of clearinghouses that the SEC seemed to hold in high regard in the past. Consider that although the SEC acknowledges that an agency may incur additional costs associated with more limited discretion, it also suggests that

> clearing agencies may not fully internalize the social costs of poor internal controls and thus, given additional discretion, may not craft appropriate risk management policies and procedures. For example, even if existing regulation provides clearing agencies with the incentives necessary to manage risks appropriately in a static sense, they may not provide clearing agencies with incentives to update their risk management programs in response to dynamic market conditions. . . . By reducing covered clearing agencies' discretion over their policies and procedures, the proposed amendments . . . may reduce the likelihood that risk management practices lag behind changing market conditions.[367]

The argument clearly disregards the historically robust Postulate III backstops. At the very least, since the major *traditional* agencies are built on a more inclusive, participatory corporate governance model and did demonstrate uninterrupted performance prior to and during the crisis, additional data and research on the matter are needed.

Another example of a supporting argument of the Commission is that clearinghouses "may fail to internalize the consequences of their risk management decisions . . . . [and that s]uch a failure represents a financial network externality imposed by clearing agencies on the broader financial markets and suggests that financial stability, as a public good, may be under-produced in equilibrium."[368] Unfortunately, the solution (i.e., imposition of more demanding regulations) does not follow from the premise. Is this approach the most apposite way to reduce the identified potential externalities? Recall also that such potential externalities did not suddenly materialize after the 2008 crisis and have been an innate feature of centralized C&S for decades. The

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365 DEPOSITORY TR. & CLEARING CORP., THE DEPOSITORY TRUST & CLEARING CORPORATION (2013), http://www.dtcc.com/~/media/Files/Downloads/About/government-relations/DTCC_One_Pager_May_2013.pdf.

366 2014 OCC Letter, *supra* note 24, at 13.

367 Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29587.

368 *Id.* at 29576.

Commission, as a sector-specific regulator, was able to successfully mitigate this risk through cooperation with the industry, principles-based philosophy, and through rule review and approval processes. By contrast, a less individualized approach in risk management may produce externalities of its own through the destructive effects of regulatory coordination or harmonization on which collectivism thrives.[369]

F. *Clearinghouses' Comments*

In conclusion, this Section briefly examines how the industry reacted to the rules. This reaction gives us a paradox. On the one hand, the traditional clearinghouses supported the more generalized approach of the SEC vis-à-vis that of the CFTC. For instance, the OCC, a dually-registered agency, naturally compared the CFTC's and the SEC's approaches, observing in its 2011 letter that it "strongly believe[d] that the degree of micro-management reflected in the CFTC's requirements should be eschewed in favor of case-by-case review of clearing organizations' proposed rule changes."[370]

The major *traditional* covered agencies, such as the DTCC's subsidiaries and the OCC, also generally support the SEC rule proposed in the 2014 Release. The DTCC, for example, observed "that the Commission has generally struck the appropriate balance between the principle and level of detailed requirements."[371]

Yet the rules are only *comparatively* flexible. The traditional supervisees were not fully satisfied with the 2012 SEC Rule, and in line with the historical regulatory equilibrium, called for preserving less prescriptive standards, more clearinghouse discretion, and principles-

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369 *See, e.g.*, Whitehead, *supra* note 12, at 351–52.

370 Letter from William H. Navin, Exec. Vice President, Gen. Counsel, & Sec'y, Options Clearing Corp., to Elizabeth A. [sic] Murphy, Sec'y, Sec. & Exch. Comm'n 2 (Apr. 29, 2011), https://www.sec.gov/comments/s7-08-11/s70811-16.pdf. The clearinghouses also expressed their belief that the rules should be not overly prescriptive, but principles-based in nature, allowing room for clearinghouse discretion in determining compliance practices. Letter from Larry E. Thompson, Gen. Counsel, Depository Tr. & Clearing Corp., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 6–7 (Apr. 29, 2011), http://www.sec.gov/comments/s7-08-11/s70811-24.pdf; Letter from Craig S. Donohue, Chief Exec. Officer, CME Grp., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 3 (Apr. 29, 2011), https://www.sec.gov/comments/s7-08-11/s70811-14.pdf.

371 Letter from Larry E. Thompson, *supra* note 12, at 3. The OCC, also agreeing with the Commission's approach, welcomed the avowed policy premise "that CCAs should be allowed 'flexibility to use their market experience and understanding of their institutions to shape the rules, policies, and procedures implementing proposed Rule….'" 2014 OCC Letter, *supra* note 24, at 3 (quoting Standards for Covered Clearing Agencies, 79 Fed. Reg. at 29517).

based regulations.[372] The supporting undertones were requesting consultations with the Commission, preserving the traditional case-by-case Commission review,[373] and even waiting until an industry consensus is reached[374] (i.e., the crucial characteristics of the precrisis cooperative equilibrium circumscribed by Postulate I). Even in their comments on the recently proposed regulations, the clearing agencies continued to insist on greater flexibility in some areas.[375]

The comments must be put in perspective. Namely, while the first round of comments still built on the previously cooperative regulatory model, the new proposed regulations and comment letters came on the heels of the IOSCO Principles, Dodd-Frank, and the designations of the clearing agencies as systemically important. Hence, by 2014, the clearing agencies, like all other market actors, were well aware of the new prescriptive and overcoordinated policies.[376] Their comments should impliedly incorporate the effects of the new framework on the SEC. It is, therefore, possible that the market believes that, absent either statutory reforms or the Fed and FSOC's policy signals, discussed in Part II, we may have reached the point of no return for the Commission.

G. *Conclusion*

To sum up, the new regulations have turned the old reform pattern (i.e., responding to fragmentary market initiatives and a crisis revealing their insufficiency through uniform regulations promoting best practices) on its head. With respect to the generality and flexibility of the regulations, the SEC appears to oscillate between the two

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372 *See, e.g.*, Clearing Agency Standards, Exchange Act Release No. 68080, 77 Fed. Reg. 66220-01, 66225–26 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240) (discussing risk-based and margin models); *id.* at 66227, 66230, 66236–27 (discussing model validation); *id.* at 66239 (discussing the participant access standards); *id.* at 66241 (discussing portfolio size and transaction volume threshold restrictions).

373 *See, e.g.*, *id.* at 66224, 66227, 66228–29, 66241–42, 66249, 66251 (discussing comments on various sections of the rule).

374 *See, e.g.*, *id.* at 66233 ("[Commenters] also urged the Commission not to require any CCP to increase its liquidity resources or otherwise re-engineer its risk management controls unless and until there is industry and regulatory consensus on the changes that should be made."); *id.* at 66235, 66255.

375 *See, e.g.*, Letter from Larry E. Thompson, *supra* note 12, at 9 ("DTCC acknowledges the importance of educating participants as to how the clearing agency approaches default management, and participants' role in such process; nevertheless, DTCC believes that this can be achieved by methods other than mandating they participate in annual closeout tests. We believe this is one area where covered clearing agencies should be afforded the discretion and flexibility to develop mechanisms to foster such education on the one hand, while separately being able to develop testing scenarios—with inclusion of those 'stakeholders' (including those of its participants) it deems appropriate and practicable—in its annual testing process.").

376 *See, e.g.*, *id.* at 2.

philosophies—the Commission seeks to remain true to its original policies while attempting to strike a balance between the traditional approach and Dodd-Frank. Unfortunately, the highlighted deficiencies and inconsistencies suggest the generic nature of the rules and their underdeveloped explanations.

Practically, the new policies mean that virtually every discussed clearing agency, including the DTC, the NSCC, and the OCC, will be subject to *additional* regulations.[377] Those regulations are no longer based on the cooperative one-regulator-one-market interaction as the Federal Reserve, the CFTC, and the SEC are now all threads of an interconnected web of FMU regulators.

Conclusion

This Article examines the new risks of the postcrisis regulatory overcoordination (i.e., *collectivism*) and contrasts them with a successful *linear* sector-specific regulatory model. The research underscores the historical importance of *cooperative* market-regulator interactions.

In particular, in clearing and settlement, a rapid introduction of the new rules for clearinghouses designated as "systemically important" under Dodd-Frank, and the risk of collectivism, may disturb the traditionally cooperative regulatory philosophy. The new policies already force the SEC to reduce clearing agencies' discretion and impose more prescriptive rules.

In developing these new standards, the SEC bears a heightened burden of ensuring that changes to the traditionally successful model do not undermine the status quo, but improve it. Most importantly, the SEC should not entirely abnegate its historical philosophy, the exacting task of avoiding "average" regulations, and the traditionally cooperative relationship with the C&S industry.

Similarly, the Fed and the FSOC should tread carefully in exercising their de facto veto authority. The Dodd-Frank coordination mechanisms should be invoked rarely, and only in cases where inefficiencies in the sector-specific model explicitly undermine its benefits built on regulatory flexibility, linearity, and cooperation between expert regulators and regulated industries.

377 The other systemically important agencies are, inter alia, CME and ICE Clear Credit. Press Release, U.S. Dep't of the Treasury, Financial Stability Oversight Council Makes First Designations in Effort to Protect Against Future Financial Crises (July 18, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1645.aspx.