

REGULATING THE MONEYCHANGERS

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INTRODUCTION

“The foreign exchange¹ . . . market is the most liquid sector of the global economy and generates the largest amount of cross-border payments on a daily basis, with an average daily turnover of \$5.3 trillion.”² That market is critical to commerce because it “facilitates international trade and investments through the determination of exchange rates, conversion of national currencies and transfer of funds.”³ This critically requires effective regulation on a global basis, especially in the United States, which is a hub for such trading because of the importance of the dollar in international trade and finance.⁴

The foreign exchange market is now regulated domestically by no less than five regulators: the Commodities Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System (Fed).⁵ Those multiple and redundant regulators have not proved to be effective or efficient in preventing abusive business practices. This is demonstrated by the recent civil and criminal actions that charged several large banks with fraud and manipulation of the foreign exchange market on

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1. “The expression ‘foreign-exchange’ refers to the exchange of money in one country for money in another.” THOMAS YORK, *FOREIGN EXCHANGE, THEORY AND PRACTICE* 1 (1920).

2. Federal Reserve Board Bank of New York, *Managing Foreign Exchange*, <http://www.newyorkfed.org/financial-services-and-infrastructure/financial-market-infrastructure-and-reform/managing-foreign-exchange/> [https://perma.cc/GS6B-2DZJ] (accessed on April 26, 2015).

3. *Id.*

4. To illustrate, the dollar was involved in eighty-seven percent of the daily turnover volume of foreign exchange in 2013. *Table-Global FX Volume Reaches \$5.3 Trillion a Day in 2013-BIS*, Reuters, Sept. 5, 2013, <http://www.reuters.com/article/2013/09/05/bis-survey-volumes-idUSL6N0GZ34R20130905> [https://perma.cc/5NYY-5HFH] (accessed on July 31, 2015).

5. See *infra* note 446 and accompanying text (describing that regulation).

a massive scale, with settlements now totaling over \$10 billion.⁶

The size and nature of the misconduct in those cases has called into question the effectiveness of the existing regulatory structure that allowed such practices to go undetected for several years.⁷ This article responds to these concerns by advocating the creation of a single business conduct regulator that would replace the existing five regulators. The article recommends that the SEC and CFTC be consolidated to act as the sole business conduct regulator for the foreign exchange market, as well as for the markets they now regulate. Both of these agencies have experience in regulating foreign exchange, and both have as their mission the sanctioning of fraud and manipulation.

The author would leave prudential regulation of the interbank exchange market to bank regulators that focus on the safety and soundness of the banking system. Foreign exchange payment and settlement systems are largely utilized by banks that can fail as a result of weaknesses in those systems. The bank regulators have historically focused on concerns over such weaknesses and should continue to do so.⁸

The article is divided into eight parts, including this Introduction. Part II covers the history of the foreign exchange market. Parts III-VI describe the development of regulation in four segments of this market: (i) the commercial interbank market; (ii) exchange traded derivatives; (iii) retail over-the-counter (OTC) derivatives; and (iv) retail OTC cash transactions. Part VII describes the existing ineffective multi-agency regulatory system and advocates for the creation of a single business conduct regulator. Finally, Part VIII concludes by proposing changes to the current regulatory framework of the foreign exchange market, noting that if these changes are successful, they could be applied to other areas of business conduct regulation.

6. See *infra* note 200 and accompanying text (describing those settlements).

7. Huw Jones, *Global Regulators to Meet in London, Fix Rules After Rigging Scandals*, Reuters, May 22, 2015, <http://www.reuters.com/article/2015/05/22/us-britain-markets-regulator-idUSKBN0071F320150522> [<https://perma.cc/96R9-KCJV>] (accessed on May 26, 2015). See also *Regulation Alone Will Not Restore Faith in Markets*, FIN. TIMES (LONDON), May 26, 2015, (describing how regulators are rethinking their regulatory approach to benchmarks such as foreign currency exchange rates), <http://www.ft.com/intl/cms/s/0/8a41dd82-0399-11e5-a70f-00144feabdc0.html#axzz3xpQTnOaa> [<https://perma.cc/JF66-2V27>] (accessed on May 27, 2015).

8. See *infra* notes 182, 434, 443 and accompanying text (describing that prudential regulation).

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I. HISTORY AND DEVELOPMENT OF THE FOREIGN EXCHANGE MARKET

A. *In the Beginning*

The history of foreign exchange in ancient times is somewhat murky and predated by exchanges of metal and barter transactions.⁹ Coins as currency appear to have their origin in Lydia, where they were first minted in the seventh century B.C.¹⁰ The use of coins as a currency soon spread to Greece and Rome.¹¹ From there money in the form of coins spread to the economies of most developing civilizations.¹² This coined currency included bezants, ecus, florins, ducats, agustalias, pfennigs, hellers, stuivers, weisspfennigs, blankes, pfunds, orrts, gulden, crona, anglots, pesos, nobles, and dinars.¹³ China is attributed with the creation of paper money, as Marco Polo discovered during his journey there in the thirteenth century. This practice eventually spread to the West.¹⁴

Currencies often circulated outside their country of origin, and moneychangers began exchanging the currency of one country for the currency of another. This required the moneychangers to assess their relative values. The most visible of these moneychangers operated in ancient Jerusalem where they changed the currency of arriving pilgrims. Those merchants performed a valuable service, but they were not popular with everyone, as demonstrated by the famous act of Jesus in overturning their tables and casting them from the Temple.¹⁵

9. PAUL EINZIG, *THE HISTORY OF FOREIGN EXCHANGE*, 11-14 (2D ED. 1970).

10. The British Museum, *The Origins of Coinage*, http://www.britishmuseum.org/explore/themes/money/the_origins_of_coinage.aspx [https://perma.cc/3EPG-SWRB] (accessed on Feb. 5, 2015).

11. *Id.*

12. Gold drove ancient commerce as a medium of exchange:

Conceivably gold could perform its monetary function in whatever shapes and sizes it chanced to be. But in that case it would be necessary on every occasion of its transfer, from buyer to seller, or between lender and borrower, to verify its quantity by means of a pair of scales and a more or less elaborate metallurgical test. It is to obviate the need of such internal weighings and testings that the metal is fashioned into stamped disks of regular shape, called 'coins' which cannot be tampered with without detection, each of a standard weight as expressed by the monetary unit.

THOMAS YORK, *FOREIGN EXCHANGE, THEORY AND PRACTICE* 3 (1920).

13. JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES, FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492-1900)* 16 (2002).

14. JACK WEATHERFORD, *THE HISTORY OF MONEY* 126 (1997).

15. PAUL EINZIG, *THE HISTORY OF FOREIGN EXCHANGE* 19 (2D ED. 1970). The activities of the Jerusalem money changers have also been described as follows:

Moneychangers appeared in Europe in the late Middle Ages.¹⁶ Those merchants tested and weighed coins being exchanged, and currency was examined to see if it was counterfeit or debased.¹⁷ These moneychangers also exercised a banking function by safekeeping coins for merchants and

In the period of the Second Temple vast numbers of Jews streamed to Palestine and Jerusalem 'out of every nation under heaven' taking with them considerable sums of money in foreign currencies. This is referred to in the famous instance of Jesus' driving the money changers out of the Temple (Matt. 21:12). Not only did these foreign coins have to be changed but also ordinary deposits were often handed over to the Temple authorities for safe deposit in the Temple treasury. Thus Jerusalem became a sort of central bourse and exchange mart, and the Temple vaults served as 'safe deposits' in which every type of coin was represented. The business of money exchange was carried out by the *shulhani* ('exchange banker'), who would change foreign coins into local currency and vice versa. People coming from distant countries would bring their money in large denominations rather than in cumbersome small coins. The provision of small change was a further function of the *shulhani*. For both of these kinds of transactions the *shulhani* charged a small fee (*agio*), called in rabbinic literature a *kolbon* (a word of doubtful etymology but perhaps from the Greek κόλλυβος 'small coin.' This premium seems to have varied from 4 percent to 8 percent. The *shulhani* served also as a banker, and would receive money on deposit for investment and pay out an interest at a fixed rate, although this was contrary to Jewish law.

Jewish Virtual Library, *Money Changers*,
http://www.jewishvirtuallibrary.org/jsource/judaica/ejud_0002_0014_0_14119.html
 [https://perma.cc/84X5-Q9BF] (accessed on Mar. 5, 2015) (citations omitted).

16. As one source notes:

If you only think about the enormous variety of coins in circulation, it becomes quite obvious money changers played an important role in the economic life of a medieval citizen. You could find them in the neighbourhood of city gates, the market square or the townhall. Easy to find for foreign merchants and travellers who had to pay them a visit in order to change their money into local currency. Just as banks today, money changers received a commission on their transactions.

National Bank of Belgium Museum, *The Money Changer's Bench*,
<http://www.nbbmuseum.be/2008/01/money-changers-bench.htm> [https://perma.cc/WNT3-G7GJ] (accessed on Mar. 5, 2015).

17. It has been noted that:

On the one hand the money changer was a private businessman but on the other hand he also had a public function. Hence, he was closely controlled by the authorities. He actually had two main tasks: as a public officer he had to withdraw all forged and clipped coins and as a private businessman he was mainly involved in changing different coin types. The first task was particularly important to ensure a sound circulation of money. Only money changers had the right to buy abraded or debased coins at metal value. This coined metal was further sold to goldsmiths or mint masters.

Id.

issuing certificates of deposits that the merchant could pass as money.¹⁸

Moneychangers also became involved in the trade in bills of exchange. These instruments operated much like the modern check in that the drawer was directing a third party (today this would be the bank) to pay the holder of the bill a stated amount in a specified currency.¹⁹ Bills of exchange were often used in foreign trade, giving rise to a need for moneychangers to convert payments into the currency of the holder.²⁰ Bills of exchange that were payable in a foreign currency were a convenient means for negating the need to transfer coins for payment in a foreign country. Bills of exchange were also used to avoid usury prohibitions by disguising interest through a favorable exchange rate.²¹

Various governmental restrictions were placed on early moneychangers in Europe. Commonly, moneychangers were required to obtain licenses from the ruling authority. “In most countries they had to conform to tightly drawn official market regulations the infringement of which entailed severe penalties.”²² Most authorities also set official exchange rates. England went further. Between the twelfth and seventeenth centuries the English Crown banned private moneychangers, placing that function into the office of the Royal Exchanger.²³

Despite their regulation, abuses were present in early foreign exchange markets. Critics of this market often claimed that exchange rates were being manipulated. In some instances, this manipulation was designed to protect local growers from foreign competition by making the cost of foreign goods more expensive.²⁴ In addition, “[t]here was much written about the speculative activity of skillful and sinister syndicates which were supposed to influence exchange rates to their advantage by spreading false rumors or by other methods.”²⁵ In the sixteenth century, betting on exchange rates became popular through futures style transactions, which developed into the more modern foreign exchange market.²⁶ The Dutch government banned such transactions in 1541.²⁷

18. *Id.*

19. Business Dictionary, *Bills of Exchange (BOF)*, <http://www.businessdictionary.com/definition/bill-of-exchange-BOE.html> [<https://perma.cc/HA57-LBY4>] (accessed on Mar. 5, 2015).

20. EINZIG, *supra* note 10, at 63-64.

21. *Id.* at 69-70.

22. *Id.* at 103.

23. *Id.* at 104.

24. *Id.* at 80.

25. *Id.*

26. *Id.* at 120.

27. *Id.*

B. *Foreign Exchange in America*

Before the Revolution, the American colonies had no single currency they could call their own. The individual colonies issued bills of credit that served in a limited fashion as a local currency. However, their value fluctuated wildly and was often discounted when used as currency. To prevent abuses in the over issuance of these bills, the Crown passed legislation restricting their issuance.²⁸ Otherwise, foreign coins, bills of exchange, transactions on account and barter were used as the basis for most colonial period commercial and retail transactions.²⁹

After the Revolution, merchants specializing in foreign exchange made their appearance in the United States.³⁰ They included Brown Bros. & Co. in New York and its Baltimore affiliate, Alexander Brown & Sons. These merchants purchased bills of exchange from other merchants and issued their own bills.³¹ By 1817, references were being made to “monied men” carrying on “extensive and profitable operations” in foreign exchange between U.S. cities.³² However, at least until the 1830s, commercial banks had little involvement in the foreign exchange market because “foreign exchange transactions were still not accepted as assuredly the proper province of such an institution.”³³ By the 1830s, “permission could be secured . . . for the mere profit making exigencies of the exchange merchants themselves, [i.e., speculation] [F]oreign-exchange trading was, indeed, ceasing to be wholly a supplementary element in international merchandising and was growing into a distinct and complicated business of itself.”³⁴

The foreign exchange market between America and London was disrupted by the Civil War.³⁵ However, the British and American Exchange Banking Corp. Ltd. was operating a foreign exchange business that used bills of lading attached to bills of exchange as collateral. The company also handled gold shipments. After the Civil War, speculators facilitated the rise of a more sophisticated trading system in foreign currency exchange. “In this connection mention may be made of a

28. MARKHAM, *supra* note 14, at 50-55.

29. Boston Federal Reserve Bank, *History of Colonial Money*, <https://www.bostonfed.org/education/pubs/historyo.pdf> [https://perma.cc/DV2W-8LBR] (accessed on March 5, 2015).

30. A.H. Cole, *Evolution of the Foreign-Exchange Market of the United States*, 1 J. ECON. & BUS. HIST. 384, 390 (1929).

31. *Id.*

32. *Id.* at 396.

33. *Id.* at 390, 394.

34. *Id.* at 404.

35. *Id.* at 417-418.

phenomenon peculiar to the boom periods around 1866 and 1873—the use of ‘borrowed’ exchange for speculative purposes.’³⁶ The post-Civil War speculators borrowed time bills from foreign exchange firms, sold those borrowed bills and used the funds generated by the sale to speculate in other markets. Further, technological advances of communications by the 1880s radically increased security speculators’ (who served as the predecessors of today’s arbitrageurs) availability of foreign exchange transactions, rendering feasible the development of a ‘retail’ market in currencies.³⁷

Futures contracts in foreign exchange were developed in the 1870s for grain exporters by the foreign exchange operations of Alexander Brown & Sons in Baltimore, Maryland. The exporters entering into those contracts were seeking to hedge the risks of foreign currency fluctuations between the time of the acceptance of a foreign grain order and its payment.³⁸ Such futures contracts were not traded on exchanges but were sold over-the-counter.³⁹

C. *The Role of Gold and Silver in Foreign Exchange*

Gold and silver historically played a central role in the foreign exchange market in the U.S. because those precious metals were, as in ancient times, the standard used to value one currency against another. There has been a long running debate of the proper ratio in valuing silver against gold. In ancient times, the ratio was generally from twelve to twenty parts silver to one part gold.⁴⁰ The Coinage Act passed by the U.S. Congress in 1792 set the value of gold to silver at a ratio of 15:1, which was a measure for pricing gold and silver coins.⁴¹ The Coinage Act of 1834 also authorized debt payments in gold and silver coins from England, France, Portugal and Brazil.⁴² Moneychangers continued to deal in other coins. For example, the firm of Spofford and Tileston was offering a premium for Mexican coins in May 1835.⁴³ Exchange in America was a confusing matter. Prices for Spanish coins were often quoted in British

36. *Id.* at 410.

37. *Id.* at 415-416.

38. Edwin J. Perkins, *The Emergence of a Futures Market for Foreign Exchange in the United States*, 11 EXPLORATIONS IN ECON. HIST. 193, 200, 202 (1974).

39. *Id.*

40. PETER L. BERNSTEIN, *THE POWER OF GOLD* 25 (2000). In Egypt around 4000 B.C. the ratio of gold was set at what appears to be a historic low of 10:1.

41. 1 Stat. 246 (1792).

42. 4 Stat. 669 (1834).

43. MARKHAM, *supra* note 14, at 179.

valuations, rather than by their dollar value.⁴⁴ However, the Coinage Act of 1857 sought to stop that business by prohibiting the use of foreign coins as legal tender.⁴⁵

The Civil War gave rise to much speculation in gold on which the value of Union currency, the “Greenbacks,” was based. The value of that currency would rise and fall with each Union victory or defeat. The price of the \$20 gold double-eagle coins, which contained about an ounce of gold, fluctuated during the war between \$135 and \$285.⁴⁶ The Confederacy created a unique instrument for foreign exchange. It was a tri-valued bond (this was the so-called Erlanger Bond named after its principal underwriter). The purchaser of the bond was given the option of receiving interest and principal payments in cotton, British sterling or French francs. However, the bond became worthless at the end of the war.⁴⁷

Speculation in gold continued after the Civil War and culminated in 1869 with Jay Gould’s epic attempt to corner that market. Gould had suborned officials in the Grant administration to withhold government sales as a means to drive up its price. However, the corner was broken after President Grant became suspicious and ordered large gold sales.⁴⁸ More important for the foreign exchange business was the post-war debate over whether the country should continue the paper currency used by the North during that conflict. Many believed that the government should return to a “specie” standard in which only gold and/or silver would be accepted as legal tender. It was thought that this would curb the speculation that had occurred during the war.⁴⁹ Such a specie standard would also reduce

44. As one author noted:

[P]eople were perfectly used to dealing in Spanish coins and giving them British valuations. Even the dollar, capstone of the Jeffersonian system, struggled for recognition. Into the 1850s the people of New England called a dollar six shillings. Nine shillings was \$1.50; ten and six meant \$1.75. A Spanish real was a New York shilling; eight reals made a dollar, and one real was worth twelve and a half cents. Ten reals made \$1.25, or ten shillings, though in Virginia a dollar and a quarter meant seven shillings and sixpence.

Americans had to price things in curious fractions, according to the coins available to them. Goods went for 6 1/4, 12 1/2, 18 3/4, 25, 37 1/2, 50, 62 1/2, and 75 cents. Things cost \$1 1/4 or \$5 7/8.

JASON GOODWIN, *GREENBACK: THE ALMIGHTY DOLLAR AND THE INVENTION OF AMERICA* 124 (2003).

45. 11 Stat. 163 (1857).

46. MARKHAM, *supra* note 14, at 270-71. In 1864, Congress prohibited futures trading in gold but this only caused the price of gold to rise against the Greenback and the legislation was repealed two weeks after its enactment. *Id.*

47. *Id.*

48. MAURY KLEIN, *THE LIFE AND LEGEND OF JAY GOULD* 99-115 (1986).

49. MARKHAM, *supra* note 14, at 339-49.

concerns over risks caused by fluctuations in foreign exchange rates in commercial transactions because gold would be exchanged for gold in settling foreign debts.⁵⁰

The specie debate was long running and contentious, even giving rise to political parties. A specie standard was opposed by farmer organizations that sought to inflate the currency and thereby inflate commodity prices. In contrast, commercial interests sought to call in paper currency and return to a more stable gold standard. A subset of this debate was an effort to treat silver more favorably than gold, which would inflate prices because of its greater supply.⁵¹ The Supreme Court entered the fray through the so-called legal tender cases, which gave conflicting rulings on whether greenbacks were required to be accepted as legal tender by anyone other than the federal government. Broad legal tender status was eventually recognized by the Court.⁵²

The Resumption Act of 1875 declared that it was the intention of the federal government to resume specie as the standard for legal tender. However, a “free Silver” movement and the “Greenback” or “National” party continued to fight that resumption. They supported the Silver Coinage Act of 1878, which required the Treasury to buy and coin silver that could be used as collateral for silver certificates that would circulate as currency. Congress also voted to reduce the amount of outstanding greenbacks, which brought them to par with gold for the first time. This debate over the role of gold and silver gave rise to one of the most famous political speeches in American history—the so-called “Cross of Gold” speech by William Jennings Bryan in 1896.⁵³ Despite his rhetoric, Bryan lost the presidential race and the argument. The United States also went on

50. For example, when the United States and England were both on a gold standard, “a bank deposit in New York [wa]s equivalent to gold tendered in New York, while a bank deposit in London [wa]s equivalent to gold tendered in London.” YORK, *supra* note 2 at 1.

51. See generally, GOODWIN, *supra* note 46, at 255-84 (describing these political issues).

52. Lane County v. Oregon, 74 U.S. 71 (1868); Bronson v. Rodes, 74 U.S. 229 (1868); Hepburn v. Griswold, 75 U.S. 603 (1869); Legal Tender Cases, 79 U.S. 457 (1870).

53. Bryan famously stated in this speech that:

[H]aving behind us the producing masses of the nation and the world. . . the commercial interests and the laboring interests and all the toiling masses, we shall answer their demands for a gold standard by saying to them, you shall not press down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold.

William Jennings Bryan, Speech at the Democratic National Convention in Chicago: Cross of Gold (July 9, 1896), <http://historymatters.gmu.edu/d/5354/> [<https://perma.cc/3BSR-GHWD>].

a gold standard in 1900 with the passage of the Gold Standard Act.⁵⁴

The adoption of a gold standard here and abroad helped to stabilize exchange rates among the countries adopting that standard, which included a majority of nations.⁵⁵ “During the gold standard, exchange rates were generally quite stable and anchored by arbitrage of gold versus currencies pegged to gold.”⁵⁶ Gold might still fluctuate in value between two foreign markets on the gold standard when there was an imbalance of supply and demand in one market.⁵⁷ However, the risks from such fluctuations could be hedged.⁵⁸ Speculators and arbitrageurs could also profit from such differences, but profits were limited to the cost of transporting gold to the market with an imbalance.⁵⁹

The gold standard fell apart in 1914 with the outbreak of World War I, which caused the warring nations to fall out of a fixed rate regimen.⁶⁰

For a short time conditions in the Foreign Exchange markets became chaotic. The interruption of relations with enemy countries made it impossible to carry out the large number of foreign-exchange contracts entered into before the war, and it became difficult to carry out a further large number of contracts whose execution depended and turned on the execution of contracts with enemy countries.⁶¹

Efforts were made to stabilize sterling by pegging operations of the government and other measures,⁶² but in “neutral markets the exchanges of

54. Jerry W. Markham, *Gold Standard Act of 1900*, ENCYCLOPEDIA.COM, <http://www.encyclopedia.com/doc/1G2-3407400146.html> [https://perma.cc/P3T2-9UMP] (last visited Mar. 15, 2015). The Wizard of Oz was written as an allegory of the fight over the gold standard. William Jennings Bryan was portrayed as the cowardly lion. WEATHERFORD, *supra* note 15, at 174-77.

55. Michael D. Bordo, *Gold Standard*, LIBRARY OF ECONOMICS AND LIBERTY, <http://www.econlib.org/library/Enc/GoldStandard.html> [https://perma.cc/5G7C-XWHK] (last visited Mar. 15, 2015).

56. Scott Mixon, *The Foreign Exchange Option Market, 1917-1921* 5 (Jan. 26, 2009), <http://ssrn.com/abstract=1333442> [https://perma.cc/S9P3-JCNL].

57. YORK, *supra* note 2, at 21-22 (1920).

58. *Id.* at 53-54.

59. *Id.* at 24-25. As one source described this speculation:

They will purchase exchange with money borrowed in New York and loan out the funds in the London market. Subsequently, when their advances mature, they will recall their funds by selling exchange, and at the same time retire their borrowings and New York. They may also speculate by purchasing exchange for future delivery.

Id. at 24.

60. Mixon, *supra* note 57.

61. EINZIG, *supra* note 10, at 236.

62. The U.S. dollar was pegged to the British pound at a set rate during the war. JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900-1970)* 73 (2002).

belligerent fluctuated freely, and there was a great deal of speculation.”⁶³

In 1919, after the conclusion of World War I, government pegging operations ended, including those by the United States and the value of the British pound and French franc dropped sharply.⁶⁴ Exchange rates “witnessed wild and entirely incalculable fluctuations, and speculation figured prominently both as a cause and as an effect of these fluctuations.”⁶⁵ This period saw an evolution in the foreign exchange markets; telegraphic transfers replaced bills of exchange and a spot and forward market in actual currency emerged.”⁶⁶ “Anecdotal evidence from contemporaries suggests that currency trading became a substantial activity starting in the 1920s, as speculators sought to exploit the new profit opportunities associated with floating exchange rates.”⁶⁷

This period of floating currency exchange rates during the 1920s was “remarkable for its great turbulence due to the political and economic conditions that existed in Europe at the time.”⁶⁸ The rapid and unprecedented depreciation of the German mark has been well documented, as has the devastating inflation experienced by that country.⁶⁹ Many blamed that inflation on speculators in the currency, rather than on the government policies and war related claims that were the actual cause.⁷⁰ There were also “concerted speculative attacks on various currencies, most

63. EINZIG, *supra* note 10, at 237.

64. BARRY EICHENGREEN, *GOLDEN FETTERS: THE GOLD STANDARD AND THE GREAT DEPRESSION, 1919-1939* 100 (1995).

65. *Id.*

66. Olivier Accominotti & David Chambers, *If You're So Smart: The Currency Trading Record of John Maynard Keynes* (Sept. 2014), http://www.cepr.org/sites/default/files/Accominotti%20-%20Chambers_IfYou'reSoSmart_20Sep2014.pdf [https://perma.cc/VY7D-TUZZ].

67. *Id.* at 1.

68. Richard T. Baillie & Young-Wook Han, *Central Bank Intervention and Properties of the 1920s Currency Markets* (Apr. 2002), http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CB4QFjAA&url=http%3A%2F%2Fwww.cb.cityu.edu.hk%2F%2FgetFileWorkingPaper.cfm%3Fid%3D279&ei=iykMVfzUGMP4gwSegoJw&usq=AFQjCNG_pRz49aTTA7ALVbdzW4eIvThAvA&sig2=hAj53OZZ5R6UM2_DPi7s5w&bvm=bv.88528373,d.eXY [https://perma.cc/KU7Y-XVJX].

69. *See Germany's Hyperinflation-Phobia*, *THE ECONOMIST*, Nov. 15, 2013, <http://www.economist.com/blogs/freeexchange/2013/11/economic-history-1> [https://perma.cc/7T4G-4DSF] (accessed on March 20, 2015) (describing that hyperinflation and the fears that it continues to raise in Germany).

70. Robert L. Hetzel, *German Monetary History in the First Half of the Twentieth Century*, at 11 (2002), https://www.richmondfed.org/publications/research/economic_quarterly/2002/winter/pdf/hetzel.pdf [https://perma.cc/J8MY-BDMV] (accessed on March 21, 2015). Germany ended its hyperinflation in 1923 by pegging the mark to the dollar at the then prevailing exchange rate of 4,200 billion marks to the dollar. *Id.* at p. 8.

notably the French franc, which in turn prompted the French Government to engage in a number of ‘bear squeezes’ in the hope of deterring future speculation.”⁷¹

The business of foreign exchange grew rapidly in the United States after the conclusion of World War I. By 1920, the *Wall Street Journal* was carrying a column on “Foreign Exchange” that analyzed causes of currency price fluctuations and carried price quotes for several European and South American currencies.⁷² Brokers were advertising their foreign exchange operations. For example, the Park Union Foreign Banking Corporation in New York advertised in the *New York Times* in 1921 that it had \$22 million in resources and that its “Foreign Exchange Department [was] taking care of the foreign exchange business in sterling, francs, lire and marks, as well as Scandinavian, Central European and Far Eastern exchange for over two hundred banks within the United States, for many foreign banks and commercial firms.”⁷³ Another New York firm, Morton Lachenbruch & Co., advertised that large profits could be made from the purchase of foreign bonds “because they rise in Dollar Value in proportion to exchange rates.”⁷⁴ The American Express Company made similar claims.⁷⁵

Options trading was a popular tool for speculation in foreign currency in the United States. Retail German-American investors were particular targets of firms hawking options on the German mark.⁷⁶ Options were also sold on the Russian ruble.⁷⁷ These options on foreign exchange were often sold “at prices too exorbitant to attract any but the uninformed . . .”⁷⁸ The exploitation of retail foreign currency investors involved other frauds, including one of the most notorious financial scandals in all history—that of Charles Ponzi.⁷⁹ His scheme promised small investors, usually Italian immigrants, quarterly profits of fifty percent through the purchase of postal reply coupons in Europe using European currencies. Ponzi claimed that these postal certificates would be redeemed in other currencies at favorable

71. Richard T. Baillie, Tim Bollerslev & Michael R. Redfean, *Bear Squeezes, Volatility Spillovers and Speculative Attacks in the Hyperinflation 1920s Foreign Exchange*, 12 J. INT’L MONEY & FIN. 511, 512 (1993).

72. See, e.g., *Foreign Exchange*, WALL ST. J., May 6, 1920, at 12; *Foreign Exchange*, WALL ST. J., Mar. 17, 1922, at 4 (describing the causes for fluctuations in price for foreign currencies).

73. Advertisement for Park-Union, N.Y. TIMES (Apr. 28, 1921) at 27.

74. Advertisement for Morton Lachenbruch & Co., N.Y. TIMES (June 1, 1921) at 30.

75. *Rise in Exchanges Aiding Bond Sales*, N.Y. TIMES, Dec. 28, 1921, at 29.

76. *Mixon*, supra note 57, at 2-3.

77. *Id.*

78. *Piratical Practices in Field of Foreign Exchange*, WALL ST. J., Mar. 8, 1922, at 4.

79. See MITCHELL ZUCKOFF, *PONZI’S SCHEME* (2005) (describing this fraud).

exchange rates.⁸⁰ In actuality, Ponzi was simply paying his investors “profits” from their own funds and those of new investors.⁸¹

The *Wall Street Journal* reported in 1922 that other Ponzi-like schemes were occurring in foreign exchange transactions directed at ethnic groups in Chicago. One operator was conducting “blind pool and exchange operation[s], so-called dividends on which actually come from the deposits of constantly recruited ‘investors’...”⁸² Another form of fraud on unsophisticated investors was reported to have involved “the sale of counterfeit foreign currencies, or money worthless because a foreign government or bank of issue had given notice that within a certain period, since elapsed, it must be presented to be stamped or exchanged.”⁸³

“Bucketing” was another fraud practiced on foreign exchange customers. This occurred when currency or foreign bonds were sold for cash or on a partial payment plan. The buyer was “told that his money must go to Europe and he is put off on one pretext or another or until the dealer is able to buy at a much better price or simply closes his office.”⁸⁴ Many of the victims of this practice were unsophisticated, but many banks and money brokers located outside the New York foreign exchange market were targeted as well.⁸⁵ The National City Bank also suffered \$5 million

80. See BARRY EICHENGREEN, *HALL OF MIRRORS* 17-18 (2015) (describing this arbitrage opportunity).

81. The Supreme Court described Ponzi’s scheme as follows:

In December, 1919, with a capital of \$150, he began the business of borrowing money on his promissory notes. He did not profess to receive money for investment for account of the lender. He borrowed the money on his credit only. He spread the false tale that on his own account he was engaged in buying international postal coupons in foreign countries and selling them in other countries at 100 per cent. profit, and that this was made possible by the excessive differences in the rates of exchange following the war. He was willing, he said, to give others the opportunity to share with him this profit. By a written promise in 90 days to pay them \$150 for every \$100 loaned, he induced thousands to lend him. He stimulated their avidity by paying his 90-day notes in full at the end of 45 days, and by circulating the notice that he would pay any unmatured note presented in less than 45 days at 100 per cent. of the loan. Within eight months he took in \$9,582,000, for which he issued his notes for \$14,374,000. He paid his agents a commission of 10 per cent. With the 50 per cent. promised to lenders, every loan paid in full with the profit would cost him 60 per cent. He was always insolvent, and became daily more so, the more his business succeeded. He made no investments of any kind, so that all the money he had at any time was solely the result of loans by his dupes.

Cunningham v. Brown, 265 U.S. 1, 7-8 (1924).

82. *Piratical Practices in Field of Foreign Exchange*, *supra* note 80.

83. *Id.*

84. *Id.*

85. *Id.*

loss in Brazil from exchange operations conducted by a rogue trader.⁸⁶

The spectacular failure of a foreign exchange firm in 1923 illustrated the growth and dangers of the foreign exchange market. That firm, Knauth, Nachod & Kuhne, was a member of the New York Stock Exchange and had been in business for seventy years. Its demise was attributed to the depreciation of the German mark.⁸⁷ That failure was followed by the bankruptcy of another New York Stock Exchange member, Zimmerman & Forshay, which was dealing in German and other foreign securities.⁸⁸ The German currency was certainly suffering that year. Reports in August 1923 indicated that the German mark was trading at the rate of “6,666,666 marks to the dollar.”⁸⁹

Despite these problems, the foreign exchange market in New York was recognized as a force in the financial community. Market commentary on foreign currency fluctuations continued to be regularly reported in the papers.⁹⁰ For example, on December 13, 1924, the *New York Times* noted that:

Activity in the foreign exchanges was greater with a considerable increase in speculative dealing, which caused irregular movements in a few currencies. Market opened with sterling and most of the smaller continentals lower, and heavy sales of sterling, francs and guilders from London during early half of the session caused further declines.⁹¹

In 1925, New York amended its Martin Act, a state law that had been originally aimed at conventional stock and bond fraud schemes, to cover foreign currency orders and options.⁹² Such legislation was necessary. At about the time of the passage of this amendment to the Martin Act, investors gave thousands of dollars to Louis Franko, who was operating in New York and offering investments in Italian lire in foreign exchange. Franko simply kept the money, but unfortunately for him one of the defrauded investors was a former sheriff of Scranton, Pennsylvania, and he had Franko arrested.⁹³

86. MARKHAM, *supra* note 63, at 112 (2002).

87. *Big Banking Firm, 70 Years in Street, Fails for \$12,000,000*, N.Y. TIMES, June 17, 1923, at 1.

88. *Old Banking House, Ex-German Agents, Fails for \$7,500,000*, N.Y. TIMES, June 21, 1923, at 1.

89. *Foreign Exchange*, WALL ST. J., Aug. 22, 1923, at 4.

90. *Stocks Again Up, Led By the Rails*, N.Y. TIMES, Dec. 13, 1924, at 8.

91. *Foreign Exchange*, N.Y. TIMES, Dec. 13, 1924, at 8.

92. *Starts a New War on Stock Swindles*, N.Y. TIMES, Apr. 3, 1925, at 6.

93. *Seized as Swindler in Foreign Money*, N.Y. TIMES, Sept. 1, 1926, at 3.

D. *The Gold Standard and Bretton Woods*

In 1924, there was speculation that Europe would return to a golden basis.⁹⁴ Great Britain returned to the gold standard in 1925,⁹⁵ and was followed by the rest of Europe in the next two years.⁹⁶ However, gold began flowing to the United States from London in 1928 when the Federal Reserve Board began raising interest rates. This disrupted efforts to maintain a gold standard with the European nations.⁹⁷

The Great Depression led the German Reichsbank to limit foreign exchange “to ‘cases of vital necessity’”⁹⁸ and England to abandon the gold standard in 1931.⁹⁹ America followed in 1933 with the election of Franklin Roosevelt. Roosevelt used his first inaugural address to vilify the “money changers,” although that pejorative seemed to have been directed at bankers in general.¹⁰⁰ In the event, Roosevelt had Congress create an Exchange Stabilization Fund that could be used to manipulate the dollar against other currencies. That Fund was also used to bail out Mexico in 1995 and to guarantee the money market funds during the Financial Crisis in 2008.¹⁰¹

The Gold Act of 1934 nationalized private gold stocks at an artificially low price.¹⁰² That action should provide an object lesson to modern investors who seek to invest in gold as a hedge against inflation. Private owners of gold were forced by the Gold Act to sell at a price of \$20.60 per ounce, which was well below the level of \$35 per ounce to which it was later inflated by Roosevelt.¹⁰³

The Gold Reserve Act of 1934 repealed the Gold Standard Act of 1900, which meant that U.S. currency was no longer redeemable in gold.¹⁰⁴

94. *Foreign Exchange*, *supra* note 90, at 8.

95. BERNSTEIN, *supra* note 41, at 291-292.

96. Hetzel, *supra* note 71, at 12-13 (2002).

97. *Id.* at 13. *See also*, LIAQUAT AHAMED, LORDS OF FINANCE 225-235 (2009) (describing Britain’s return to the gold standard).

98. EICHENGREEN, *supra* note 81, at 147.

99. MARKHAM, *supra* note 63, at 191.

100. Franklin D. Roosevelt, President of the U.S., Inaugural Address (Mar. 4, 1933), <http://www.presidency.ucsb.edu/ws/index.php?pid=14473> [https://perma.cc/3M4T-QVR8]. Roosevelt also stated in that address:

The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.

Id.

101. BEN S. BERNANKE, THE COURAGE TO ACT 301-302 (2015).

102. MARKHAM, *supra* note 63, at 191-194.

103. *Id.* at 191-192.

104. *Id.* at 193.

Congress also declared that private contract provisions for payment in gold were void.¹⁰⁵ The Silver Purchase Act of 1934 sought additionally to inflate silver prices.¹⁰⁶ Congress created a \$2 billion fund to stabilize exchange rates, and the government used that authority in 1935 to stop a run on the French franc in 1935.¹⁰⁷

The outbreak of World War II in 1939 resulted in a devaluation of the British pound, and the foreign exchange market came to a near standstill during the war.¹⁰⁸ Once it was clear that the war was won, England and the United States led the effort to create a stable monetary system through the so-called Bretton Woods agreement.¹⁰⁹ This arrangement pegged currency prices of participating nations to the dollar, which in turn was pegged to gold at a price of \$35 per ounce.¹¹⁰

The International Monetary Fund (IMF), created to act as a lender to countries that needed funding to maintain the stability of their currencies,¹¹¹ had to deal with various post-war economic crises that involved, among others, the massive devaluation of the British pound in 1949.¹¹² There were other problems that eventually led to the abandonment of the Bretton Woods currency stabilization structure. Beginning late in the 1950s, gold began to leave the United States in “the American gold crisis . . . in great part the result of American expenditures for European recovery and defense.”¹¹³ Those trade imbalances and then inflation led to an attack on the dollar in which U.S. currency was exchanged for gold at the U.S.

105. *Id.* at 191-192. The government built the gold depository at Fort Knox, Kentucky to hold the gold stocks purchased under this program. *Id.* at 195.

106. *Id.* at p. 194-195.

107. *Id.* at p. 193-194.

108. See EINZIG, *supra* note 10, at 227 (“During the second World War stability of exchange rates was maintained in most countries through a complete suspension of dealings and the adoption of advanced exchange control.”).

109. BERNSTEIN, *supra* 41, at 331. As one author has noted:

The plans for a new international economic system were worked out by 730 delegates from 44 countries who gathered in the White Mountain resort of Bretton Woods, New Hampshire, in 1944. Most of the final design came from John Maynard Keynes, representing the British Treasury, and his counterpart, Harry White of the US Treasury Department.

Id. John Maynard Keynes had been among those speculating in the foreign exchange market after World War I. 2 ROBERT SKIDELSKY, JOHN MAYNARD KEYNES, THE ECONOMIST AS SAVIOUR, 1920-1937, at 41 (1992).

110. BERNSTEIN, *supra* note 41, at 332.

111. MARKHAM, *supra* note 63, at 276.

112. *Id.*

113. ARTHUR M. SCHLESINGER JR. A THOUSAND DAYS: JOHN F. KENNEDY IN THE WHITE HOUSE 653 (2002).

Treasury, sharply depleting America's gold stocks.¹¹⁴ U.S. gold stocks dropped from \$22 billion to \$17 billion between 1958 and 1960.¹¹⁵ President John F. Kennedy prohibited Americans from holding gold abroad and sought to limit foreign investments by Americans.¹¹⁶ Those and other efforts were unsuccessful. Several efforts were also made to maintain gold at \$35 per ounce, including the formation of a gold pool by eight European countries in 1960 that sought to support the dollar.¹¹⁷

"[B]y 1955, current account convertibility was largely established de facto; at the end of 1958 it was publicly announced. . . . [C]onvertibility was the final stage of liberalization, which ensured that consumers could achieve the maximum satisfaction . . . by being able to trade at world prices."¹¹⁸ Commercial firms engaged in international business and wealthy individuals began maintaining working balances in foreign currencies to meet operational needs and to satisfy their "speculative instincts."¹¹⁹ Speculators began trading in foreign currencies and gold in anticipation of devaluations. In 1960, speculators were buying and selling gold at \$40 per ounce, while the U.S. was selling it for \$35 per ounce.¹²⁰

In 1963, *Fortune* magazine noted that individuals had become interested in hedging and speculating on the devaluation of the dollar. The article also noted that banks were "apt to acquiesce readily enough when one of their important customers indicates firmly that he wants to speculate in foreign exchange."¹²¹ At that time foreign exchange contracts traded in this so-called "interbank market" were "similar to the standard commodity-futures contract," which did not include any intent of making or taking delivery of the underlying foreign currency that was being exchanged.¹²² Small speculators did not have access to the interbank currency market but sometimes used their stockbrokers as intermediaries with the large banks.¹²³

By 1968, American gold stocks were down to \$12.4 billion and

114. MARKHAM, *supra* note 63, at 326.

115. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM, 1970-2001, at 36 (2002).

116. SCHLESINGER JR., *supra* note 114, at 510.

117. *Id.*

118. C. Fred Bergsten & John Williamson, *Currency Convertibility in Eastern Europe*, 43 Fed. Reserve Bank of Kansas City (1990), <https://www.kansascityfed.org/publicat/sympos/1990/S90BERGS.pdf> [<https://perma.cc/NC6Q-HXSL>] (last visited Mar. 3 2016).

119. *Id.*

120. MARKHAM, *supra* note 63, at 326.

121. Daniel Seligman, T.A. Wise & Carol J. Loomis, *Personal Investing*, FORTUNE, Feb. 1963, at 201.

122. *Id.* at 202.

123. *Id.* at 201.

falling.¹²⁴ The run on gold was not halted until August 15, 1971, when President Richard M. Nixon took America off the gold standard. The president closed the gold window and announced that the U.S. would no longer honor the Bretton Woods pledge to peg the price of gold at \$35 per ounce.¹²⁵ This action was called the “Nixon shock” and within a few years the dollar was floating against other currencies at exchange rates set by the market.¹²⁶

Governments, nevertheless, periodically intervened to manipulate their currencies. For example, in the 1980s, the dollar appreciated sharply against other currencies, which hurt U.S. exports. This led to the so-called “Plaza Accord” in 1985; that agreement was entered into by the U.S., Japan, West Germany, France and England after the dollar had depreciated by almost 50 percent.¹²⁷

Another example of government intervention was the Exchange Rate Mechanism (ERM) that was created in 1979 by members of the European Community, predecessor to the European Union. The ERM was a joint effort by European Community countries to stabilize their currency exchange rates against each other, while floating against other currencies. This was a precursor to the introduction of the euro in 1999,¹²⁸ which sought to eliminate currency risk in transactions occurring among businesses in the European Union.¹²⁹ The ERM was not entirely successful. England was forced from that arrangement after speculators attacked its currency in 1992. Those speculators “borrowed UK gilts only to sell them and buy them back later at cheaper prices. They repeated the trick every few minutes, making a profit each time.”¹³⁰ One of those speculators, George Soros’ Quantum Fund, made an estimated 1 billion pounds from such trading.¹³¹

124. MARKHAM, *supra* note 116, at 36-37.

125. *Id.* at 38.

126. *Id.* at 38-39.

127. THOLOOR M. THOMAS, BULL RUN 11 (2013).

128. *Econ 355: European Exchange Rate Mechanism (ERM)*, AM. UNIV. OF BULG https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=7&ved=0CE4QFjAG&url=http%3A%2F%2Fhome.aubg.bg%2Ffaculty%2Fdidar%2FEUR324%2FEuropean%2520Exchange%2520Rate%2520Mechanism%2528ERM%2529.doc&ei=m9c8VZWmK9DjsATij4C4DQ&usg=AFQjCNE6reCAL3Uzz99VbyI3_G6fS-qsNw&sig2=okjGd8ZwVr0wgkk-gldqRg [https://perma.cc/BZC5-H6H7] (last visited Apr. 26, 2015).

129. EICHENGREEN, *supra* note 81, at 71.

130. Philip Inman, *Black Wednesday 20 Years On: How the Day Unfolded*, THE GUARDIAN (Sept. 13, 2012), <http://www.theguardian.com/business/2012/sep/13/black-wednesday-20-years-pound-erm> [https://perma.cc/2D6L-SG36].

131. *Id.*

Governments continue to intervene in the currency markets.¹³² “In the modern era, a country trying to manage its exchange rates typically buys or sells its currency in the market, or uses capital controls or other regulations to restrict its use. Such practices are still common among emerging markets, notably China.”¹³³ Most recently, Greece’s economic problems have threatened its ability to stay in the euro zone and the European Central Bank intervened to prop up banks in that country.¹³⁴

II. REGULATION OF THE INTERBANK CURRENCY MARKET

A. *Growth of the Market*

Prior to the Nixon shock, an interbank foreign exchange market was operating, “but it was an exclusive club that operated in the shadows of international high finance.”¹³⁵ The banks trading in this market bought and sold currencies off the official exchange rates “at slight fluctuations among themselves or for their big commercial customers, locking the public out of the market.”¹³⁶ However, within a few years after the breakdown of Bretton Woods, the banks developed a more sophisticated interbank foreign exchange market.

Many of the larger banks created separate divisions or foreign exchange departments staffed with personnel that specialized in making markets in currencies. Those banks executed transactions for large multi-

132. For example, the European Union created an ERM II in 1999, which sought to “ensure that exchange rate fluctuations between the euro and other EU currencies do not disrupt economic stability within the single market, and to help non euro-area countries prepare themselves for participation in the euro area.” *What is ERM II?*, EUROPEAN COMM’N (July 23, 2014), http://ec.europa.eu/economy_finance/euro/adoption/erm2/index_en.htm [https://perma.cc/GQJ5-Y67B].

133. Greg Ip, *Currencies Gyrate, But There’s No War*, WALL ST. J. (Mar. 12, 2015), <http://www.wsj.com/articles/currencies- gyrate- but- theres- no- war- 1426094448> [https://perma.cc/T24L-GKFR]. In 2015, the U.S. entered into a pact with several Pacific Rim countries that sought to deter currency manipulations done for the purpose of benefitting trade. *12 Pacific Rim Countries Sign Pact to End Currency Manipulation*, INT’L BUS. TIMES (Nov. 6, 2015), <http://www.ibtimes.co.in/12-pacific-rim-countries-sign-pact-end-currency-manipulation-653611> [https://perma.cc/9XAF-GVY8].

134. Spiegel & Jones, *supra* note 133. The Chinese government devalued its currency, the yuan, sharply beginning on August 10, 2015, which makes imports into that country more expensive and exports cheaper. This raised concerns over trade wars. Lingling Wei, *China Moves to Devalue Yuan*, WALL ST. J. (Aug. 11, 2015), <http://www.wsj.com/articles/china-moves-to-devalue-the-yuan-1439258401> [https://perma.cc/6DT3-TGZ2].

135. LEO MELAMED, *ESCAPE TO THE FUTURES* 170 (1996).

136. *Id.*

national corporations, other banks and speculators.¹³⁷ This market grew rapidly because “[f]oreign-exchange dealings no longer concerned just the multinational companies, the biggest banks, and the wealthiest individuals. Anybody doing business handling money on an international basis is affected.”¹³⁸ Individuals and companies sought to protect their assets, and speculators sought a profit.¹³⁹

A sophisticated payment system developed to facilitate transactions in the interbank foreign exchange market. The Clearing House Interbank Payments System (CHIPS) was created just before the Nixon shock to act as “an electronic payments system that transfers funds and settles transactions in U.S. dollars. CHIPS enables banks to transfer and settle international payments more quickly by replacing official bank checks with electronic bookkeeping entries.”¹⁴⁰ “Historically, CHIPS specialized in settling the dollar portion of foreign exchange transactions, and CHIPS estimates that it now handles 95 percent of all U.S. dollar payments moving between countries.”¹⁴¹ CHIPS also played an important role in an event that led to the regulation of the interbank foreign exchange market.

B. *Creation of the Basel Committee*

“After the collapse of Bretton Woods, many banks incurred large

137. Stewart L. Brown & Dekle Day, *Federal Regulation of Foreign Currency Trading for Future Delivery on Interbank and Futures Markets*, 9 FLA. ST. U. L. REV. 69, 71-72 (1981).

138. *Everybody Plays the Currency Game*, BUS. WEEK, May 4, 1974, at 34. As another source noted:

[F]loating exchange rates permanently destabilized global commerce, creating artificial advantages and real losses almost at random. Currency values were pushed back and forth in unpredictable ways that no business executive could reasonably foresee. Every multinational corporation became, perforce, a gambler in currency markets.

WILLIAM GREIDER, *SECRETS OF THE TEMPLE* 339 (1987).

139. *Id.*

140. *CHIPS*, N.Y. FED. RESERVE BANK (Apr. 2002), <http://www.newyorkfed.org/aboutthefed/fedpoint/fed36.html> [<https://perma.cc/WE4A-8XFY>]. As described by one court:

The New York Clearing House Association (“Clearing House”) maintains computer facilities and implements techniques for the transfer of funds among its member banks. In June, 1974 the Clearing House was using the Clearing House Interbank Payments System (“CHIPS”), a computerized interbank system for the transfer of funds involving international customers of Clearing House member banks.

Delbrueck & Co. v. Mfr. Hanover Trust Co., 464 F. Supp. 989, 992 (S.D. N.Y. 1979).

141. *CHIPS*, *supra* note 142.

foreign currency losses.”¹⁴² One of the more spectacular of those losses occurred at the Bankhaus Herstatt in West Germany on June 28, 1974. Its failure from some \$200 million in foreign currency exchange losses touched off an international banking crisis.¹⁴³ Because of time differences, U.S. banks had made their daily payments through CHIPS to Bankhaus Herstatt but had not received their exchange payments from that bank before its failure, which meant that they would only have a claim in bankruptcy for their reciprocal payments. This time gap between settlement payments became known as the “Herstatt risk;” banks using the CHIPS payment system then refused, for a time, to make further payments through that system for fear that they would not receive reciprocal payment should a counterparty bank fail.¹⁴⁴ The failure of the Franklin National Bank in the U.S. at about the same time as the Herstatt debacle raised further concerns over foreign exchange transactions. At that time, the Franklin National Bank was the largest bank failure in U.S. history. Its collapse was due in large measure to \$47 million in losses from foreign exchange trading.¹⁴⁵

The failure of Franklin National and Bankhaus Herstatt led to an international effort to regulate the interbank foreign currency market.¹⁴⁶ This regulation was coordinated through the Basel Committee on Banking Supervision (Basel Committee) that was created by the Bank for International Settlements (BIS) in 1974.¹⁴⁷ The Basel Committee “has its origins in the financial market turmoil that followed the breakdown of the Bretton Woods system of managed exchange rates in 1973.”¹⁴⁸

“In response to these and other disruptions in the international financial markets, the central bank governors of the G10 [Group of Ten] countries established a Committee on Banking Regulations and Supervisory Practices at the end of 1974”¹⁴⁹ which was later renamed the

142. *A Brief History of the Basel Committee*, BANK FOR INT’L SETTLEMENTS, <http://www.bis.org/bcbs/history.htm> [<https://perma.cc/Z6DK-C924>] (last visited Apr. 21, 2015).

143. The failure of “a small German bank sent shock waves through the system, costing banks from New York to Singapore some \$620 million in losses.” Gergana Koleva, *‘Icon of Systemic Risk’ Haunts Industry Decades After Demise*, AM. BANKER (June 23, 2011), <http://www.americanbanker.com/bankthink/bankhaus-herstatt-icon-of-systemic-risk-1039312-1.html> [<https://perma.cc/LJS9-LU3H>].

144. MARKHAM, *supra* note 116, at 20.

145. *Id.* at 19-20.

146. Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 77 Fed. Reg. 69694, 69703 (Nov. 20, 2012).

147. BANK FOR INT’L SETTLEMENTS, *supra* note 144.

148. *Id.*

149. *Id.*

“Basel Committee on Banking Supervision”¹⁵⁰ The Basel Committee created a supervising agreement called the “Concordant”¹⁵¹ that set supervisory procedures for international banks. “The Concordat set out principles for sharing supervisory responsibility for banks’ foreign branches, subsidiaries and joint ventures between host and parent (or home) supervisory authorities.”¹⁵²

C. Settlement Risks

In 1980, the G10 countries created a “Group of Experts on Payment Systems.”¹⁵³ This group conducted a review of the payment systems in the G10 countries and published its findings in 1983 in what were called “Red Books.”¹⁵⁴ Those Red Books provided a comprehensive description of the payment, clearing and settlement systems of numerous countries.¹⁵⁵ In 1989, the G10 countries created a Committee on Interbank Netting Schemes (CINS). That committee published a report in 1990 that set forth “minimum standards for the operation of bilateral and multilateral cross-border and multicurrency netting schemes and sets out the G10 central banks’ framework for the cooperative oversight of such systems.”¹⁵⁶ In 1990, the G10 countries created the Committee on Payment and Settlement Systems, which was later renamed the Committee on Payments and Market Infrastructures (CPMI).¹⁵⁷ This permanent committee oversees international payment systems. It is also a member of the Financial Stability Board (FSB), the successor to the Financial Stability Forum. The Group of Twenty countries gave the FSB an expanded role after the

150. *Id.*

151. *Id.*

152. *Id.* This did not stop problems in the foreign exchange market. In 1975, a whistleblower at Citibank claimed that a senior currency trader was taking kickbacks and that the bank was parking profits from currency trading in the Bahamas in order to evade U.S. taxes. Eric Dash, *Edwin Edwards*, 62, *Figure in Citibank Currency Case, Dies*, N.Y. TIMES (Dec. 29, 2006), http://www.nytimes.com/2006/12/29/business/29EDWARDS.html?pagewanted=print&_r=0 [https://perma.cc/QQ57-BAC6] (last visited Apr. 26, 2015). At the time, Citibank was conducting about ten percent of the world’s foreign exchange transactions, and by 1978 the bank was earning over \$100 million from that trading. PHILLIP L. ZWEIG, WRISTON 605 (1995). The whistleblower’s allegations resulted in eight years of investigations by Congress and the Securities and Exchange Commission but no wrongdoing was ever charged. See MARKHAM, *supra* note 116, at 65 (describing these events).

153. *About the CPMI*, BANK FOR INTERNATIONAL SETTLEMENTS (Sept. 1, 2014), <http://www.bis.org/cpmi/info.htm?m=3%7C16%7C2> [https://perma.cc/6S9E-ETUJ].

154. *Id.*

155. *Id.*

156. *Id.* The membership in this committee later expanded to twenty-five countries. *Id.*

157. *Id.*

Financial Crisis of 2008. It is now broadly tasked with coordinating and promoting more effective regulatory and supervisory policies in the entire financial sector.¹⁵⁸

U.S. regulators were also focusing on foreign exchange operations by banks. A 1989 Banking Circular issued by the Office of the Comptroller of the Currency (OCC) advised the banks it regulated that they must make periodic risk assessments of their international payment systems. This Circular also noted that international payment systems posed risks in various forms, including operational reliability, liquidity and the credit quality of counterparties.¹⁵⁹

Still, problems surfaced periodically in the interbank foreign currency market. The failure of Drexel Burnham Lambert in 1990 caused concern with the foreign exchange operations of a London affiliate of that broker-dealer.¹⁶⁰ The Bank of England intervened and created a facility for the settlement of that affiliate's foreign exchange transactions. The Bank of England essentially acted as an escrow agent to ensure that the parties on both sides of those trades would be paid.¹⁶¹ The failure of the BCCI SA bank in 1991 caused losses to foreign exchange counterparties. A London foreign exchange counterparty lost a large sum because of a delay in a settlement payment from BCCI due to a U.S. holiday. The London counterparty paid, but during the delay, BCCI failed and its counter payment was canceled. A large Japanese bank also suffered losses because it paid on a foreign exchange transaction with a BCCI affiliate but did not receive a counter payment before BCCI failed, which caused its accounts to be frozen.¹⁶²

Political problems in the Soviet Union caused further disruptions in 1991. An attempted coup d'état created uncertainty as to the ability of some Soviet Union financial institutions to perform on their foreign exchange contracts. This disruption was only temporary, however, because the counterparties were able, with some assistance from government authorities, to reach a resolution with the Soviet institutions.¹⁶³ The bankruptcy of Baring Brothers in 1995 also temporarily disrupted foreign

158. *Our History*, FINANCIAL STABILITY BOARD (2016), <http://www.financialstabilityboard.org/about/history/> [<https://perma.cc/R8VT-DPNM>].

159. COMPTROLLER OF THE CURRENCY ADMINISTRATOR OF NATIONAL BANKS, BANKING ISSUANCE (1989).

160. Gabriele Galati, *Settlement Risk in Foreign Exchange Markets and CLS Bank*, BIS QUARTERLY REVIEW, Dec. 2002, at 56.

161. COMMITTEE ON PAYMENT AND SETTLEMENT SYSTEMS OF THE CENTRAL BANKS OF THE GROUP OF TEN COUNTRIES, SETTLEMENT RISK IN FOREIGN EXCHANGE OPERATIONS 6 (1996).

162. *Id.* at 7.

163. *Id.* at 7-8.

currency settlements in Europe.¹⁶⁴

In order to reduce the foreign exchange settlement risks that leave a counterparty exposed to the risk of the failure of its opposing party, a group of large banks formed the CLS Bank International in 2002.¹⁶⁵ The CLS Bank seeks to reduce this so-called “Herstatt risk” by requiring simultaneous settlement payments by each party to a foreign exchange transaction, i.e., delivery-versus-payment.¹⁶⁶

Bank regulators continued to strengthen the supervision of foreign exchange operations. In September 2000, the Basel Committee provided supervisory guidance for managing settlement risk in foreign exchange operations.¹⁶⁷ It noted that settlement risks from foreign currency exchange involved “daily exposures of tens of billions of dollars for the largest banks. Most significantly, for banks of any size, the amount at risk to even a single counterparty could in some cases exceed their capital.”¹⁶⁸ Among other things, this report noted that supervision of settlement risks should be carried out by the highest levels of bank management with supervision from the bank’s board of directors.¹⁶⁹

Despite the creation of the CLS Bank, settlement risk remained. A 2008 report by the Committee on Payment and Settlement Systems found that 32 percent of foreign exchange transactions surveyed by the committee were done outside the CLS Bank. These settlements were done through traditional correspondent banking relationships, and half of those

164. *Id.* at 8.

165. *About Us*, CLS (2015), <http://www.cls-group.com/About/Pages/default.aspx> [<https://perma.cc/KC2T-2J8U>].

As the CLS Bank noted:

All members of the FX community potentially bear the risk of loss of principal due to settlement risk. Settlement risk, also known as “Herstatt risk,” is widely recognized as the most significant systemic risk to participants in the FX market, meaning the mitigation of it is a high priority for the community as a whole.

Settlement Risk, CLS (2015), <http://www.cls-group.com/Pages/default.aspx> [<https://perma.cc/EB87-6EXE>].

166. *See Galati, supra* note 162, at 56-64 (describing the settlement process that arose through the CLS after the closure of Bankhaus Herstatt).

169. *See* BASEL COMMITTEE ON BANKING SUPERVISION, SUPERVISORY GUIDANCE FOR MANAGING SETTLEMENT RISK IN FOREIGN EXCHANGE TRANSACTIONS 1 (2000) (explaining the purpose of its 2000 report as providing information about settlement risk and management).

167. *See* BASEL COMMITTEE ON BANKING SUPERVISION, SUPERVISORY GUIDANCE FOR MANAGING SETTLEMENT RISK IN FOREIGN EXCHANGE TRANSACTIONS 1 (2000) (explaining the purpose of its 2000 report as providing information about settlement risk and management).

168. *Id.* at 1.

169. *Id.* at 3.

settlements were found to have overnight risk exposure.¹⁷⁰ Several recommendations were made by the committee to reduce that exposure, including greater use of bilateral netting arrangements that would reduce gross exposures.¹⁷¹

Still more guidance was provided by the Basel Committee in 2012 for managing risks associated with settlement of foreign exchange settlements.¹⁷² Those risks were identified as “principal risk, replacement cost risk, liquidity risk, operational risk and legal risk.”¹⁷³ A principal recommendation was the reduction of settlement risks by delivery-versus-payment systems.¹⁷⁴ Concerns remained with respect to settlement. In 2013, the New York Federal Reserve Bank demanded that banks provide better management of foreign currency exchange risks.¹⁷⁵

With all this supervision, no one was able to anticipate the surprise decision of the Swiss government to decouple its currency from the euro in January 2015. The result was that the Swiss franc increased in value by nearly forty percent in one day, causing some crippling losses. Everest Capital Global, a hedge fund, lost a reported \$830 million in a single day after the Swiss franc was decoupled.¹⁷⁶ Another large hedge fund, COMAC, shut down its operations after experiencing large losses from the Swiss franc.¹⁷⁷ FXCM Inc., a U.S. based retail foreign exchange broker, had to obtain \$300 million from an investment firm in order to cover its losses.¹⁷⁸ Citigroup shut down a foreign exchange trading program for

170. *Id.*

171. *Id.* at 2.

172. BASEL COMMITTEE ON BANKING SUPERVISION, SUPERVISORY GUIDANCE FOR MANAGING RISKS ASSOCIATED WITH THE SETTLEMENT OF FOREIGN EXCHANGE TRANSACTIONS 3-4 (2012).

173. *Id.* at 3.

174. *Id.* This guidance was updated in 2013. See BASEL COMMITTEE ON BANKING SUPERVISION, SUPERVISORY GUIDANCE FOR MANAGING RISKS ASSOCIATED WITH THE SETTLEMENT OF FOREIGN EXCHANGE TRANSACTIONS 3-5 (2013) (providing the 2013 updates).

175. *Managing Foreign Exchange Risk*, FEDERAL RESERVE BOARD BANK OF NEW YORK, <http://www.newyorkfed.org/financial-services-and-infrastructure/financial-market-infrastructure-and-reform/managing-foreign-exchange/> [https://perma.cc/9XVZ-RPHK].

176. Katherine Burton, *Swiss Franc Trade Said to Wipe Out Everest's Main Fund*, BLOOMBERG BUSINESS (Jan. 18, 2015, 7:02 PM), <http://www.bloomberg.com/news/articles/2015-01-17/swiss-franc-trade-is-said-to-wipe-out-everest-s-main-fund> [https://perma.cc/6SGV-QAT2].

177. Brian Portnoy, *Hedge Funds and the 'Swiss Miss'*, FORBES (Jan. 23, 2015, 3:36 PM), <http://www.forbes.com/sites/brianportnoy/2015/01/23/hedge-funds-and-the-swiss-miss/> [https://perma.cc/3NQU-FQ9W].

178. Ira Iosebashvili, et al., *Surge of Swiss Franc Triggers Hundreds of Millions in Losses*, WALL ST. J. (Jan. 16, 2015, 7:02 PM), <http://www.wsj.com/articles/swiss-franc-move-cripples-currency-brokers-1421371654> [https://perma.cc/SF5Y-TFWK].

wealthy clients who sustained large losses from the franc revaluation.¹⁷⁹ Deutsche Bank lost about \$150 million during this event, and Barclays had large losses.¹⁸⁰

D. *Swap and Other OTC Instruments in the Interbank Market*

The interbank exchange market encompasses a broad range of trading in cash currency, swaps, options and other derivatives.¹⁸¹ The Dodd-Frank Act that was passed in 2010 required central clearing for most swaps and other OTC derivative instruments. Regulators were directed to set margin requirements for any remaining uncleared OTC swaps or other OTC derivatives. Capital and margin requirements for uncleared swaps (including initial and variation margin) for banks were to be set by the appropriate prudential bank regulator, while the CFTC was given that role for other entities.¹⁸²

The Basel Committee worked with the board of the International Organization of Securities Commissions (IOSCO) to formulate requirements for centralized clearing for standardized swaps and margin requirements for uncleared swaps and other OTC derivatives in which banks participate as principal.¹⁸³ However, Dodd-Frank allowed the Secretary of the Treasury to exempt foreign exchange swaps and forwards from the definition of “swap” for most Dodd-Frank purposes, including margin and central clearing requirements.¹⁸⁴ The Treasury Secretary made that determination on November 20, 2012.¹⁸⁵ After examining the risks presented by foreign exchange transactions in the interbank currency market, the Secretary concluded that the market was already subject to extensive and coordinated oversight by the largest central bank regulators.

179. Chiara Albanese & Peter Rudegeair, *Citigroup Closes Exclusive Credit Program Following Swiss Franc Losses*, WALL ST. J. (May 14, 2015, 6:24 AM), <http://www.wsj.com/articles/citigroup-closes-exclusive-credit-program-following-swiss-franc-losses-1431599055> [<https://perma.cc/P7XE-M749>].

180. Iosebashvili, *supra* note 180.

181. *See generally*, FEDERAL RESERVE BOARD, *TURNOVER SURVEY 2* (2010) (describing instruments traded in the interbank currency market).

182. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 731(e)(1)(A) (2010) (“Each registered swap dealer and major swap participant for which there is a prudential regulator shall meet such minimum capital requirements and minimum initial and variation margin requirements as the prudential regulator shall by rule or regulation prescribe . . .”).

183. BASEL COMMITTEE ON BANKING SUPERVISION, *MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES 1* (2012).

184. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 721 (2010) (defining “swaps” and “foreign exchange swaps”).

185. Dept. of the Treasury, *supra* note 148, at 69, 694.

The Secretary specifically cited the operations of the Committee on Payment and Settlement Systems as providing the needed regulation. The Secretary also noted that the CLS Bank and the development of delivery-versus-payment arrangements had reduced settlement risks. As a further protection, the Federal Reserve Board regularly conducts reviews of the foreign exchange operations of large banks to measure the depth of their risk assessment programs and operational procedures. That information is then shared with the Basel Committee for international coordination. The Secretary believed that this process negated the need for a central clearing and trading mandate for the interbank currency market.¹⁸⁶

E. *Fraud and Price Fixing in the Foreign Exchange Interbank Market*

1. Introduction

In recent years, several large banks became involved in high profile scandals involving their manipulation of foreign exchange rates and defrauding of institutional customers. The market they were accused of manipulating—the commercial interbank foreign exchange market—was described as follows:

Currencies are traded in pairs where the seller sells one currency and buys another, and the price of one currency is expressed in relation to another currency as a ratio. To initiate an FX transaction, typically, a customer contacts a dealer bank for a quote for the relevant currency and quantity. The dealer provides a “bid,” which is the price at which the dealer is willing to buy the currency. The dealer also quotes an “ask,” the price at which the dealer is willing to sell the currency. The difference between the bid and ask is called the “bid-ask spread,” which is the basis of the dealer’s compensation. While “dealers are incentivized to quote wider bid-ask spreads,” competition among them “narrows bid-ask spreads.” Currencies are commonly traded at published exchange rates called “fixing rates.” The WM/Reuters published rates “are the most important fixing rates in the FX markets” and “the primary benchmark for currency trading globally.” . . .

For the most widely traded currencies, the Fix is determined by the median price of actual FX transactions in the 30 seconds before and after 4 p.m. London time (the “Fixing Window”). The WM Company extracts actual market prices from electronic communications networks that Defendants use to execute orders

186. *Id.* at 69, 698.

for FX instruments, such as Reuters, Currenex and EBS. The process is automated and anonymous. Trading at the Fix is popular for many reasons, including reduced tracking error and the perception of “universality and independence from any specific dealer.”¹⁸⁷

The Justice Department has further described this interbank foreign exchange market as follows:

The FX Spot Market is an over-the-counter market and, as such, is decentralized and requires financial institutions to act as dealers willing to buy or sell a currency. Dealers, also known throughout the FX Spot Market as market makers, therefore play a critical role in ensuring the continued functioning of the market. . . .

A dealer in the FX Spot Market quotes prices at which the dealer stands ready to buy or sell the currency. These price quotes are expressed as units of a given currency, known as the “counter” currency, which would be required to purchase one unit of a “base” currency, which is often the U.S. dollar and so reflects an “exchange rate” between the currencies. Dealers generally provide price quotes to four decimal points, with the final digit known as a “percentage in point” or “pip.” A dealer may provide price quotes to potential customers in the form of a “bid/ask spread,” which represents the difference between the price at which the dealer is willing to buy the currency from the customer (the “bid”) and the price at which the dealer is willing to sell the currency to the customer (the “ask”). A dealer may quote a spread, or may provide just the bid to a potential customer inquiring about selling currency or just the ask to a potential customer inquiring about buying currency.

. . . A customer wishing to trade currency may transact with a dealer by placing an order through the dealer’s internal, proprietary electronic trading platform or by contacting the dealer’s salesperson to obtain a quote. When a customer accepts a dealer’s quote, that dealer now bears the risk for any change in the currency’s price that may occur before the dealer is able to trade with other dealers in the “interdealer market” to fill the order by buying the currency the dealer has agreed to sell to the customer, or by selling the currency the dealer has agreed to buy from the customer. A dealer may also take and execute orders

187. *In re Foreign Exchange Benchmark Rates Antitrust Litigation*, 74 F.Supp.3d 581, 586-87 (S.D.N.Y. Jan. 28, 2015).

from customers such as “fix orders,” which are orders to trade at a subsequently determined “fix rate.” When a dealer accepts a fix order from a customer, the dealer agrees to fill the order at a rate to be determined at a subsequent fix time based on trading in the interdealer market. Two such “fixes” used to determine a fix rate are the European Central Bank fix, which occurs each trading day at 2:15 PM (CET) and the World Markets/Reuters fix, which occurs each trading day at 4:00 PM (GMT).¹⁸⁸

Before the recent scandals, fraud and manipulation had been rare in the foreign exchange interbank market, at least in comparison to other financial markets. Nevertheless, there had been some problems. For example, the SEC settled a case brought against a former portfolio and currency manager for Merrill Lynch, who was charged with fraud in foreign exchange transactions that occurred between 1997 and 2001.¹⁸⁹ The defendant allegedly executed foreign customer orders but delayed their allocation. If the trade turned out profitable at the close of the London market, the defendant would allocate the trade to the accounts of his favored customers, even though they had not entered the order. The disfavored customers received less favorable prices.¹⁹⁰

In another instance, the European Commission (EC) fined five German banks about \$90 million for fixing their currency conversion commissions at about three percent during the transition to the euro starting in January 1999.¹⁹¹ A large number of other banks and bureau de change across the eurozone were the target of cartel proceedings by the EC for similar conduct. Those proceedings were discontinued after the parties agreed to reduce their commissions significantly.¹⁹²

In 2002, John Rusnak, a rogue trader in the Baltimore, Maryland office of an affiliate of Allied Irish Banks, lost \$750 million as the result of unauthorized trades in foreign exchange. Later, Allied Irish Banks came under investigation by Irish authorities over whether it had been overcharging foreign exchange customers in currency conversions.¹⁹³

188. Plea Agreement at 4-5, *United States v. JPMorgan Chase & Co.*, (2015).

189. See Gobora, SEC Litigation Release No. 17555 (June 11, 2002), <https://www.sec.gov/litigation/litreleases/lr17555.htm> [https://perma.cc/6BYB-ZRGP] (summarizing the action taken by the SEC in *SEC v. Gobora*).

190. *Id.*

191. EC Competition Committee, *Annual Report on Competition Policy Developments in European Commission*, 10 (2001), http://ec.europa.eu/competition/international/multilateral/2001_annual_report.pdf [https://perma.cc/VXB3-3TW3].

192. *Id.* at 11-12.

193. Helena Keers, *AIB Admits Overcharging*, THE TELEGRAPH (May 7, 2004), <http://www.telegraph.co.uk/finance/2884790/AIB-admits-overcharging.html>

In 2003, forty-seven foreign currency traders were charged with criminal fraud by the U.S. attorney in New York through a sting operation called operation “Wooden Nickel.” Among other things, the government charged that the defendants had defrauded large banks through trades rigged by bank employees to assure profits to non-bank traders, who then kicked back part of the profits to the bank employees.¹⁹⁴ The banks that were victimized by this conduct included JPMorgan Chase, UBS, and Société Générale.¹⁹⁵

The National Australian Bank, that country’s largest bank and second largest company, suffered a loss of \$458 million from the unauthorized foreign exchange trading of a rogue employee in 2004.¹⁹⁶ As a result of that loss, the bank’s management was restructured and several employees were forced to resign, including its CEO and chairman.¹⁹⁷

2. The Post Financial Crisis Foreign Currency Scandals

After the Financial Crisis of 2008, several large banks were the targets of regulators for their banking practices in a successive series of cases that settled for billions of dollars. The first wave of these scandals involved abusive mortgage practices. By October 2014, it was estimated that the six largest U.S. banks had paid \$143.2 billion to regulators to settle mortgage related claims.¹⁹⁸ In a second wave of cases, many of the same banks were

[<https://perma.cc/C4UA-TXS2>].

194. JERRY W. MARKHAM, A FINANCIAL HISTORY OF MODERN U.S. CORPORATE SCANDALS: FROM ENRON TO REFORM 490 (2006). Kenneth N. Gilpin, *47 Currency Traders Are Indicted on Fraud Charges*, N. Y. TIMES (Nov. 19, 2003), <http://www.nytimes.com/2003/11/19/business/19CND-DOLL.html> [<https://perma.cc/7C3C-6AP3>].

195. MARKHAM, *supra* note 193, at 490.

196. *Id.* at 496.

197. *Heads Roll at NAB Over Foreign Exchange Scandal*, SYDNEY MORNING HERALD (Mar. 12, 2004), <http://www.smh.com.au/articles/2004/03/12/1078594547046.html> [<https://perma.cc/7JTJ-EEAU>].

198. Lynnley Browning, *Too Big to Tax: Settlements Are Tax Write-offs for Banks*, NEWSWEEK (Oct. 27, 2014), <http://www.newsweek.com/2014/11/07/giant-penalties-are-giant-tax-write-offs-wall-street-279993.html> [<https://perma.cc/K7XD-TSDX>]. Bank of America alone has paid some \$90 billion to settle government and private claims over lending practices by the bank and its affiliates. John Maxfield, *The Complete List: Bank of America’s Legal Fines and Settlements Since 2008*, THE MOTLEY FOOL, (Oct. 1, 2014, 9:59 AM), <http://www.fool.com/investing/general/2014/10/01/the-complete-list-bank-of-americas-legal-fines-and.aspx> [<https://perma.cc/62XG-NMWD>]. JPMorgan Chase contributed \$26 billion to that total. Emily Glazer & Patrick Fitzgerald, *J.P. Morgan Wins Legal Battle in WaMu Case*, WALL ST. J. (June 4, 2014), <http://www.wsj.com/articles/j-p-morgan-wins-legal-battle-in-washington-mutual-case-1433365003> [<https://perma.cc/MV74-JAXS>].

charged with manipulating LIBOR and other interest rate benchmarks. The settlements with regulators in those cases totaled some \$9 billion.¹⁹⁹ A third wave of scandals followed by investigations into whether some of those same large banks had been manipulating foreign exchange rates and defrauding their institutional clients in foreign exchange transactions. The government then brought cases against several of those banks, which were settled in amounts totaling some \$10 billion.²⁰⁰ The following is a description of those foreign exchange related actions.

3. The J.P. Morgan et al. First Settlement

In November 2014, six banks agreed to pay \$4.3 billion to settle claims that they had manipulated the WM/Reuters benchmark currency rate and improperly shared information about customer orders. The charges in those actions included a claim that:

Traders at different Banks formed tight knit groups in which information was shared about client activity, including using code names to identify clients without naming them. These groups were described as, for example, “*the players*”, “*the 3 musketeers*”, “*1 team, 1 dream*”, “*a co-operative*” and “*the A-team*”.

199. Jeffrey Vogelli & Hugo Miller, *Deutsche Bank Libor Damage Goes Beyond Record \$2.5 Billion Fine*, BLOOMBERG BUS. (April 23, 2015), <http://www.bloomberg.com/news/articles/2015-04-23/deutsche-bank-libor-damage-goes-beyond-record-2-5-billion-fine> [<https://perma.cc/AK37-3PBF>]. Two London based traders were convicted in New York on charges they manipulated LIBOR rates. Christopher M. Matthews, *Jury Delivers First U.S. Libor Manipulation Convictions*, WALL ST. J. (Nov. 6, 2015), <http://www.wsj.com/articles/new-york-jury-convicts-former-rabobank-traders-in-libor-trial-1446742694> [<https://perma.cc/4FG5-9QVK>]. A trader in London was found guilty of manipulating Libor rates by an English jury, but six other traders were found not guilty of such charges in a separate trial. Chad Bray, *Sixth Ex-Broker Cleared in London Libor Trial*, N. Y. TIMES, (Jan. 28, 2016), <http://www.nytimes.com/2016/01/29/business/dealbook/sixth-ex-broker-cleared-in-london-libor-trial.html> [<https://perma.cc/T2XC-2E7U>].

200. See, e.g., Chiara Albanese, David Enrich & Katie Martin, *Citigroup, J.P. Morgan Take Brunt of Currencies Settlement*, WALL ST. J. (Nov. 12, 2014), <http://www.wsj.com/articles/banks-reach-settlement-in-foreign-exchange-rigging-probe-1415772504> [<https://perma.cc/SY5E-HJ8F>] (summarizing some of the relative fines doled out by various U.S. regulators to each of the major banks); see also, Michael Corkery & Ben Protess, *5 Big Banks to Pay Billions and Plead Guilty in Currency and Interest Rate Cases*, N.Y. TIMES (May 20, 2015), <http://www.nytimes.com/2015/05/21/business/dealbook/5-big-banks-to-pay-billions-and-plead-guilty-in-currency-and-interest-rate-cases.html> [<https://perma.cc/4TTU-ALH6>] (describing more settlements between banks and regulators).

Traders shared the information obtained through these groups to help them work out their trading strategies. They then attempted to manipulate fix rates and trigger client “stop loss” orders (which are designed to limit the losses a client could face if exposed to adverse currency rate movements). This involved traders attempting to manipulate the relevant currency rate in the market, for example, to ensure that the rate at which the bank had agreed to sell a particular currency to its clients was higher than the average rate it had bought that currency for in the market. If successful, the bank would profit.²⁰¹

This settlement was reached with a host of regulators including the Financial Conduct Authority (FCA) in London, the CFTC, the OCC and the Swiss Financial Market Supervisory Authority. The settling banks were Citigroup, JPMorgan, UBS, Royal Bank of Scotland, HSBC and Bank of America. Citigroup and JPMorgan each paid about \$1 billion in that settlement.²⁰² The Swiss Financial Market Supervisory Authority also

201. Press Release, Financial Conduct Authority, *FCA Fines Five Banks £1.1 Billion for FX Failings and Announces Industry-Wide Remediation Program*, (Nov. 12, 2014), <http://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings> [https://perma.cc/5WU7-RAA6].

202. Suzi Ring & Liam Vaughan, *Citigroup, JP Morgan Pay Most in \$4.3 Billion FX Rig Cases*, BLOOMBERG BUS. (Nov. 12, 2014), <http://www.bloomberg.com/news/articles/2014-11-12/banks-to-pay-3-3-billion-in-fx-manipulation-probe> [https://perma.cc/X7A8-ESR7]. The CFTC described the process for fixing currency benchmarks as follows:

The WM/R Rates, one of the leading and most widely referenced FX benchmark rates, are calculated multiple times daily, including at 4 p.m. London time, which is commonly referred to as the “4 p.m. fix.” For twenty-one of the most liquid currencies (the “trade currencies”), the 4 p.m. fix is based on actual trades, using bids and offers extracted from a certain electronic trading system during a one minute window (“fix period”). WM/Reuters determines the bid and offer rates based on the captured transacted rate and the bid-offer spread. WM/Reuters then calculates the median of these bid and offer rates and from these medians determines a “mid trade rate.” If there are not enough trades, WM/Reuters calculates a “mid order rate.” All orders and transactions are weighted equally, regardless of their notional sizes.

The WM/R Rates for the other 139 less liquid currencies (the “non-trade currencies”) are set by similar methodology. Because these currencies are less liquid, WM/Reuters relies on indicative quotes (submissions) derived from a Reuters computer feed that solicits “indications of interest” from market participants as part of its fixing methodology. WM/Reuters captures independent snapshots of indicative quotes for bids and offers, and selects the median rate from these quotes as the 4 p.m. WM/R fix.

WM/Reuters also provides fix rates for forward and non-deliverable forward

required UBS to limit the compensation of its foreign exchange traders. UBS was also required to automate at least nine percent of its foreign currency exchange trading and to more effectively manage conflicts of interest through the separation of customer and proprietary trading.²⁰³

Barclays dropped out of the settlement talks concerning its actions in the foreign currency market. However, the bank set aside \$1.8 billion to cover potential fines from its foreign exchange trading and, as described below, did later settle regulatory actions over its foreign exchange trading activities.²⁰⁴

4. The JPMorgan *et al.* Second Settlement

The Justice Department conducted a separate investigation of the foreign exchange operations of the usual suspects, *i.e.*, the large banks. A settlement of those claims was delayed because the Justice Department demanded that the banks plead guilty to criminal charges.²⁰⁵ Settlements with the Justice Department, and with other U.S. regulators, were eventually reached in May 2015 that required the payment of \$5.6 billion by six large banks, *viz.*, UBS AG, Barclays, Citigroup, JPMorgan Chase, Bank of America, and the Royal Bank of Scotland.²⁰⁶ All of these banks, except Deutsche Bank, had been involved in the earlier \$4.3 billion

contracts using methodology similar to that used for non-trade currencies. Fix rates for forward and non-deliverable forward contracts are published using a premium or discount to the spot rate for the relevant currency pair.

Other FX benchmark rates are also priced through the use of indicative rates. For instance, the Russian Ruble/U.S. Dollar Emerging Markets Trade Association (“EMTA”) benchmark rates are based on indicative rates submitted by market participants to the Chicago Mercantile Exchange (“CME”), which takes the midpoint of submitted bid offer pairs that it randomly selects, discards the highest and lowest midpoints, and calculates the final benchmark rate using the mean of the remaining midpoints.

HSBC Bank plc, CFTC Docket No. 15-07 (2014).

203. Swiss Financial Market Supervisory Authority, *FINMA Sanctions Foreign Exchange Manipulation at UBS*, (Nov. 12, 2014), <http://www.finma.ch/e/aktuell/Pages/mm-ubs-devisenhandel-20141112.aspx> [<https://perma.cc/MJR4-Y7QX>].

204. *Barclays Reports Loss after Forex Probe Provision*, FIN. TIMES (LONDON), (Mar. 3, 2015), <http://on.ft.com/1NW8C6t> [<https://perma.cc/5RZT-B5MJ>].

205. Ben Protess & Jessica Silver-Greenberg, *Justice Department is Seeking Felony Pleas by Big Banks in Foreign Currency Inquiry*, N.Y. TIMES, (Feb. 9, 2015), <http://dealbook.nytimes.com/2015/02/09/u-s-is-seeking-felony-pleas-by-big-banks-in-foreign-currency-inquiry/> [<https://perma.cc/3WQQ-JYNP>].

206. Vogelli & Miller, *supra* note 201. *See also* Corkery & Protess, *supra* note 202 (discussing how the four large global banks plead guilty to federal crimes involving a scheme to manipulate the world’s currencies).

settlement described above.²⁰⁷

In the May 2015 settlement UBS AG agreed to pay \$202 million to the Justice Department and \$342 million to the Federal Reserve Board. UBS also agreed to plead guilty to one count of criminal fraud. The fine and guilty pleas were based on a claim that UBS' foreign exchange activities breached a prior non-prosecution agreement that was entered into as a part of the LIBOR settlement described above.²⁰⁸ Such agreements allow a party to avoid criminal prosecution for a crime (*e.g.*, the LIBOR manipulation) on the condition that they engage in no other criminal activity for some specified period of time. UBS also agreed to pay the Connecticut Department of Banking for "unsafe . . . practices related to its [foreign-exchange] market activity."²⁰⁹

Barclays agreed with the Department of Justice to plead guilty to criminal antitrust violations for its foreign exchange transgressions. It also agreed to pay a total of \$2.4 billion to settle claims brought by the CFTC, the Federal Reserve Board, the U.K. Financial Conduct Authority and the New York Department of Financial Services. The latter regulator also required Barclays to fire eight employees.²¹⁰ Barclays was additionally found to have breached its LIBOR non-prosecution agreement through its foreign exchange trading and was fined \$60 million for that violation. In November 2015, Barclays also settled claims brought by the State of New York that it abused a so-called "last look" trading procedure on its electronic currency exchange trading platform at the expense of customers. "Last look" allowed the bank a small period of time to cancel a trade it accepted after the fact where market conditions changed adversely. This feature was intended to be a defense against HFTs, but was abused by using it to cancel customer trades that were part of their regular market-making activities but which would have caused the bank a loss.²¹¹

JPMorgan Chase was required to pay a total of \$892 million to the Department of Justice and Federal Reserve Board in these second round

207. See VOGELLI & MILLER, *supra* note 201 and accompanying text (summarizing the penalties paid by various large banks).

208. Antoine Gara, *Swiss Bank UBS to Pay \$342 Million Currency Manipulation Fine, Plead Guilty on LIBOR*, FORBES, (May 20, 2015), <http://www.forbes.com/sites/antoinegara/2015/05/20/swiss-bank-ubs-to-pay-342-million-currency-manipulation-fine-plead-guilty-on-libor/#1236d5d7f706> [https://perma.cc/DE8K-U3UB]

209. *Id.*

210. Corkery & Protess, *supra* note 202.

211. Greg Farrell, *Barclays Pays \$150 Million to Settle New York Currency Probe*, BLOOMBERG BUS. (Nov. 18, 2015), <http://www.bloomberg.com/news/articles/2015-11-18/barclays-pays-150-million-to-settle-new-york-currency-probe> [https://perma.cc/ZBN7-8ACR].

settlements. Citigroup agreed to pay a total of \$1.26 billion. The Royal Bank of Scotland agreed to pay \$669 million, and Bank of America agreed to pay the Federal Reserve Board \$205 million.²¹²

The plea agreements with the Justice Department charged that the defendant banks conspired to fix, stabilize, maintain, decrease or increase the price of and rig bids and offers for the EUR/USD currency pairs by eliminating competition. It was further alleged that this was done through daily conversations in an electronic chat room, sometimes in code. This chat room was called the “cartel” or the “Mafia,” and membership was limited to employees of the co-conspirator banks.²¹³ Through these conversations the defendants coordinated:

the trading of the EUR/USD currency pair in connection with European Central Bank and World Markets/Reuters benchmark currency “fixes” which occurred at 2:15 PM (CET) and 4:00 PM (GMT) each trading day; and (ii) refraining from certain trading behavior, by withholding bids and offers, when one conspirator held an open risk position, so that the price of the currency traded would not move in a direction adverse to the conspirator with an open risk position.²¹⁴

5. The BONY Settlement

Separate actions were brought against the Bank of New York Mellon (BONY) by the Justice Department, the Department of Labor, the SEC, the New York attorney general (NYAG),²¹⁵ and the Florida attorney general.²¹⁶ The NYAG charged that BONY had promised certain foreign exchange customers that they would receive the “best execution,” the “best rate of the day,” and the “the most attractive/competitive rate available to the Bank.”²¹⁷ In fact, as alleged by the NYAG, BONY was executing those orders at the worst rate traded during the trading date and kept the

212. Gina Chon, Caroline Binham & Laura Noonan, *Six Banks Fined \$5.6 Bn Over Rigging of Foreign Exchange Markets*, FIN. TIMES (LONDON) (May 20, 2015, 6:37 PM), <http://on.ft.com/1EjpSHB> [<https://perma.cc/4Q5S-XXTE>].

213. Plea Agreement at 4(i), *United States v. Barclays, PLC* (2015).

214. *Id.* at 4(h).

215. *BNY to Pay \$714 Million to Settle Foreign Exchange Cases*, FORTUNE, Mar. 19, 2015, <http://fortune.com/2015/03/19/bny-mellon-settlement-exchange/> [<https://perma.cc/4VUC-KXNA>].

216. News Release, Att’y Gen. Pam Bondi, Attorney General Pam Bondi Announces \$28 Million Settlement with Bank of New York Mellon (Nov. 1, 2013), <http://www.myfloridalegal.com/newsrel.nsf/newsreleases/B342E613410013CA85257C160065FCD8> [<https://perma.cc/4SMU-WJEN>].

217. *People v. Bank of N.Y. Mellon Corp.*, No. 114735/09, 40 Misc.3d 1232[A], 2013 NY slip op 51394[U].

difference between that worst price and the price existing at the time of execution. It was further alleged in the New York action that BONY made some \$2 billion from these transactions over the course of a decade.²¹⁸

A New York Supreme Court judge held that these allegations were sufficient to make out a case under the New York Martin Act against BONY.²¹⁹ The New York court in the BONY case considered whether the New York Martin Act covered the foreign currency exchange transactions at issue. As described above,²²⁰ the Martin Act was amended in 1925 to extend its coverage to foreign currency orders.²²¹ BONY contended that this term did not apply to currency transactions executed pursuant to standing instructions from customers that directed currency transactions to be executed automatically without price negotiation. The court declined to rule on that claim because it had an insufficient basis to decide the issue. The court also found the legislative history of the Martin Act amendment with respect to that term to be scant and its meaning unclear.

A federal court dismissed some charges brought by the Department of Justice, but allowed a claim over whether BONY misrepresented that it was providing best execution prices for foreign exchange to go forward.²²² That court also allowed similar claims in class actions brought by BONY custodial clients over these practices to proceed.²²³ However, that decision may not be consistent with an earlier opinion by the Fourth Circuit in *Salomon Forex, Inc. v. Tauber*.²²⁴ In *Tauber*, the court rejected a claim that a dealer had made an oral agreement that a customer would receive the “best price” because the defendant had touted its execution abilities. The court noted that all trades had been confirmed in writing. Although the confirmations did not include any “best pricing” clause, the plaintiff never objected to the terms of the contracts.²²⁵

BONY settled these state and federal claims and related class actions for \$714 million in March 2015.²²⁶ However, this case did not end the

218. *Id.* at 2.

219. *Id.* at 13.

220. *See, supra* note 93 (describing how the Martin Act was amended to cover foreign currency orders and options).

221. N.Y. Gen. Bus. Law § 352(1) (McKinney 2015).

222. *U.S. v. Bank of N.Y. Mellon*, 941 F. Supp. 2d 438 (S.D.N.Y. 2013).

223. *See, e.g., In re Bank of N.Y. Mellon Corp. Forex Transactions Litig.*, 921 F. Supp.2d 56 (S.D.N.Y. 2013) (denying bank’s motion to dismiss transportation authority’s claims alleging the bank’s failure to provide best execution price for funds’ exchange transaction).

224. *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966, (4th Cir. 1993), *cert. denied*, 511 U.S. 1031 (1994).

225. *Id.* at 979.

226. *BNY to Pay \$714 Million to Settle Foreign Exchange Cases*, *supra* note 215.

foreign exchange investigations of the large banks by New York. The New York Department of Financial Services, an agency separate from the NYAG, was conducting an investigation of the electronic trading platforms created by the large banks for trading foreign exchange. That agency was apparently concerned that the banks were manipulating prices or engaging in abusive trading practices on those platforms.²²⁷ The New York attorney general also launched an investigation to determine whether several large traders were “spoofing” trades in the foreign exchange market. Spoofing involves the entry of orders a trader intends to cancel before execution in order to mislead other traders on market conditions.²²⁸

6. State Street Bank Action

The state of California sued State Street Bank, claiming that the state’s two giant public employee pension funds had been defrauded by foreign exchange overcharges.²²⁹ State Street paid \$60 million to settle a class action suit over that issue that was brought in Massachusetts, and it remained under investigation by the SEC.²³⁰

7. Bank of England Scandal

Improper sharing and aggregation of institutional customer orders for foreign exchange caused a scandal at the Bank of England in 2014, which was made aware of such practices as early as 2006. The Bank suspended one of its employees in March 2014 in connection with an investigation of that trading. That suspension was followed by others at BNP Paribas and Bank of America who were sharing customer information. Some two-dozen foreign exchange traders were suspended or fired as a result of this

227. Gina Chon & Ben McLannahan, *NY Regulator Raises Spectre of Further Forex Penalties for Banks*, FIN. TIMES (LONDON), May 22, 2015, <http://www.ft.com/intl/cms/s/0/092572d2-0005-11e5-abd5-00144feabdc0.html#axzz47RavEjHo> [<https://perma.cc/GF3S-SJX5>].

228. Liz Moyer, *New York Opens Inquiry Into Electronic Trade ‘Spoofing,’* N.Y. TIMES, Nov. 23, 2015, http://www.nytimes.com/2015/11/24/business/dealbook/new-york-opens-inquiry-into-electronic-trade-spoofing.html?WT.mc_id=SmartBriefs-Newsletter&WT.mc_ev=click&_r=0 [<https://perma.cc/6YWR-6XUU>].

229. Press Release, Att’y Gen. Kamala D. Harris, *Brown Sues State Street Bank for Massive Fraud Against CalPERS and CalSTRS* (Oct. 20, 2009), <https://oag.ca.gov/news/press-releases/brown-sues-state-street-bank-massive-fraud-against-calpers-and-calstrs> [<https://perma.cc/7X45-VLEN>].

230. Andrew Harris, *State Street Agrees to Settle Forex Fee Suit for \$60 Mln*, BLOOMBERG BUSINESS, July 9, 2014, <http://www.bloomberg.com/news/articles/2014-07-09/state-street-agrees-to-settle-forex-fee-case-for-60-mln> [<https://perma.cc/HR6E-AYQQ>].

inquiry.²³¹

A subsequent investigation concluded that the Bank of England's chief foreign exchange dealer was aware that traders were sharing aggregated information about customer orders in order to match those orders with others. Such matching was itself not improper but presented the opportunity for collusive conduct.²³² Another report asserted that a Bank of England official was included on emails of traders discussing the manipulation of the currency prices.²³³

8. Class Actions

The press reported that foreign exchange traders among several large banks and a large energy firm were using chat rooms to exchange information that allowed them to manipulate the market and take advantage of customer orders.²³⁴ Several class actions were brought over this activity. A district court denied a motion to dismiss consolidated class actions challenging the foreign currency trading practices under the Sherman Antitrust Act.²³⁵

The complaint in this case charged that the defendants had conspired to manipulate the daily Fix rate.²³⁶ That manipulation was alleged to have occurred through concerted trading strategies that were formulated in “chat rooms, with evocative names such as ‘The Cartel,’ ‘The Bandits’ Club,’

231. *Bank, Fix Thyself*, THE ECONOMIST, Mar. 8, 2014, <http://www.economist.com/news/finance-and-economics/21598678-bank-england-faces-questions-over-its-role-rigged-forex-deals-bank-fix> [<https://perma.cc/N3MM-WEZ6>].

232. Lord Grabiner QC, *Bank of England Foreign Exchange Market Investigation*, Report, <http://www.bankofengland.co.uk/publications/Documents/news/2014/grabiner.pdf> [<https://perma.cc/KB46-KPTV>] (last visited May 5, 2015).

233. David Enrich, *Bank of England Official Received Emails Relating to Libor Manipulation, Prosecutor Says*, WALL ST. J., May 27, 2015, <http://on.wsj.com/1V3AGns> [<https://perma.cc/8NXU-CUSW>].

234. Liam Vaughan, *Cartel: How BP Used a Secret Chat Room for Insider Tips*, BLOOMBERG BUSINESS, Dec. 29, 2014, <http://www.bloomberg.com/news/articles/2014-12-30/cartel-chat-room-tied-to-bp-gave-fx-tips-from-banks-to-client> [<https://perma.cc/3E7N-D9CL>].

235. 15 U.S.C. § 1, 2.

236. *In re Foreign Exch. Benchmark Rates Antitrust Litig.*, 74 F. Supp. 3d 581 (S.D.N.Y. 2015).

The daily “fixing” of rates sets a benchmark for pricing currencies:

Institutions find it useful to take a snapshot of how much is being bought and sold. This happens every day in the 30 seconds before and after 16:00 in London and the result is known as the 4pm fix, or just the fix. The fix is very important, as it is the peg on which many other financial markets depend.

Sebastian Chrispin, *Forex Scandal: How to Rig a Market*, BBC (May 20, 2015), <http://www.bbc.com/news/business-26526905> [<https://perma.cc/5ULZ-9H3C>].

The ‘Mafia’ and ‘One Team, One Dream’”²³⁷ Through those chat rooms, the defendants’ foreign exchange traders were alleged to have shared market-sensitive information, including “information about pricing,” their customers’ orders and their net trading positions in advance of 4 p.m. London time.

Using this nonpublic information, the defendants were alleged to have set the Fix at an artificial level by “banging the close” through trades broken up into small orders that would have a greater cumulative effect on the Fix and by “painting the screen” through fake orders.²³⁸ The defendants were also charged with “front running” customer orders.²³⁹ Three of the defendant banks settled these actions. UBS AG paid \$135 million in that settlement; JPMorgan Chase & Co. paid \$99.5 million.²⁴⁰ Bank of America agreed to pay an additional \$180 million.²⁴¹ More settlements followed, and by August 2015, the total agreed to be paid in these class action lawsuits exceeded \$2 billion. The additional settling banks included Goldman Sachs, HSBC Holdings Plc, Barclays, Plc, and BNP Paribas, SA; more settlements were expected from seven other large banks that were also named as defendants in that litigation.²⁴²

9. Regulatory Response

The U.S. Justice Department was reported to have expanded its investigations into foreign currency manipulations in 2015 to include the Russian ruble and Brazilian real and was considering actions against individual traders.²⁴³ Bank regulators were also seeking enhancements in the regulation of the interbank exchange market after the price

237. In re Foreign Exch., 74 F. Supp. 3d at 587.

238. *Id.* at 594.

239. *Id.* Front running involves a broker trading for its own account with knowledge that a customer will be trading at a price that will allow the broker to profit from its prior trade. See Jerry W. Markham, “Front-Running”—*Insider Trading Under the Commodity Exchange Act*, 38 CATH. U. L. REV. 69 (1988) (describing front running concerns).

240. Eric Larson & Phil Milford, *BofA Investors Say Settlement Reached in Forex Class Action*, BLOOMBERG BUSINESS, Apr. 16, 2015, <http://www.bloomberg.com/news/articles/2015-04-16/bofa-investors-say-settlement-reached-in-forex-class-action> [<https://perma.cc/U884-CFHT>].

241. Christina Rexrode, *Bank of America to Pay \$180 Million to Settle Investors’ Forex Lawsuit*, WALL ST. J., Apr. 29, 2015, <http://www.wsj.com/articles/bank-of-america-to-pay-180-million-to-settle-private-forex-lawsuit-1430340190> [<https://perma.cc/EB3C-RRY2>].

242. Nate Raymond, *Currency-Rigging Lawsuit Settlements Rise Past \$2 Billion: Lawyer*, REUTERS, Aug. 13, 2015, <http://www.reuters.com/article/2015/08/13/us-forex-manipulation-settlement-idUSKCN0QI2J720150813> [<https://perma.cc/L76K-AXYW>].

243. Tom Schoenberg & Silla Brush, *U.S. Currency Probe Said to Expand to Russia, Brazil*, 47 SEC. REG. & L. REP. (BNA) 1748 (Aug. 31, 2015).

manipulation scandals emerged. The U.K. required the setting of eight benchmarks, including Libor and precious metals, to be administered by independent administrators that the FCA would regulate like public utilities.²⁴⁴ This plan, however had a few obvious flaws, *i.e.*, who will assure that the independent administrator's exchange rate setting is fair and is not itself manipulated, as was the case with the California electricity market at the turn of the century.²⁴⁵

The FCA also announced that it was implementing a "remediation" program that would require firms operating in the interbank foreign exchange market to review their supervisory controls to assure they were sufficient to manage their foreign exchange risks. Managers at those firms were also required to attest that their controls were adequate.²⁴⁶ Despite these efforts, the FCA was complaining some five years after the disclosure of the Libor manipulations that the rate setting mechanism for that benchmark was still broken.²⁴⁷

The Bank of England considered whether to require that foreign exchange transactions be time-stamped to show when they were executed. This would allow a customer to determine if they received a fair price based on the market at the time of the time stamp.²⁴⁸ A global code of conduct was also being considered by central banks that would, among other things, provide guidance on what constitutes confidential customer information and what information may be disclosed to other traders, particularly information concerning orders submitted for execution in the daily benchmark fixing sessions.²⁴⁹ This effort was being led by the Bank for International Settlements.²⁵⁰

244. Huw Jones, *UK Watchdog Proposes New Rules to Avoid Excessive Fees for Benchmarks*, REUTERS, June 3, 2015, <http://www.reuters.com/article/2015/06/03/britain-regulations-markets-idAFL5N0YP27820150603> [https://perma.cc/6YSF-54MT].

245. See Jerry W. Markham & Lawrence Hunt Jr., *The California Energy Crisis—Enron's Gaming of Governor Gray's Imperfect Market*, 24 *Fut. & Derv. L. Rep.* 1 (2004) (describing those manipulations).

246. FCA, *supra* note 203.

247. Juliet Samuel and Chiara Albanese, *No Fix for Libor: Benchmark Still Broken, Regulators Say*, WALL ST. J., July 7, 2015, <http://www.wsj.com/articles/libor-reform-has-not-gone-far-enough-says-regulator-1436195584> [https://perma.cc/VL4L-C4K2].

248. Sheryl Gesto Obejera, *Report: UK Treasury Wants BoE to Consider Time Stamps for Forex Trades*, SNL, Apr. 6, 2015, <http://www.smartbrief.com/04/07/15/boe-reportedly-faces-pressure-weigh-fx-time-stamp#.V5aM51w-BBw> [https://perma.cc/4VKF-P7SY].

249. Patrick Graham, *Exclusive: Central Banks Agree New Rules for FX Market Conduct*, REUTERS, Mar. 23, 2015, <http://in.reuters.com/article/2015/03/23/us-fx-investigation-idINKBN0MJ1NI20150323> [https://perma.cc/P8CP-7C8P].

250. Patrick Graham, *2-BIS Sets Sights on Single Global FX Code of Conduct*, REUTERS, May 11, 2015, <http://uk.reuters.com/article/2015/05/11/forex-codes-idUKL5N0Y22QS20150511> [https://perma.cc/Z29H-VZTB]. The Financial Stability Board, which coordinates international banking regulation, reported in October 2015 that

III. THE RETAIL OTC FOREIGN EXCHANGE CASH MARKET

The dissolution of the Bretton Woods fixed exchange rate regime led to the vast expansion of the commercial interbank foreign exchange market. It also led to the rapid growth of a retail market for foreign exchange for international travelers. Those retail dealers in foreign currencies were often found in kiosks in airports and on the streets of popular tourist destinations. Bank branches also provided foreign exchange services.²⁵¹ In making exchange transactions, travelers are required to exchange at the dealer's quoted bid or ask price, a difference that is called a "spread." This spread is the dealer's profit in foreign exchange transactions. Consequently, there will nearly always be a difference between the quoted bids and offers, the bid being lower than the offer.²⁵²

To illustrate, someone traveling to London changing dollars into pounds would pay a retail dealer rate at the quoted ask price from the branch office of a bank or currency kiosk on the street. When returning to the United States, that traveler would, assuming the dealer's spread has not changed, exchange any remaining pounds for dollars at a rate lower than she received when selling those same dollars. This is the spread through which these moneychangers profit. That traveler may also be charged an additional service fee or commissions by dealers, thereby further increasing the cost of the currency conversion. All things being equal, the dealer will profit on the difference in the spreads. In fact, all things might not be equal, as when the dealer has an imbalance of currency in inventory that declines. The dealer will be constantly adjusting its spread prices to reflect changes in the relative value of the currencies in which it deals.²⁵³

In contrast to the dealer, a speculator will try to profit from changes in the relative value of one currency versus another. For example, a speculator might exchange pounds for dollars at today's rate in hopes that those pounds will increase in value and can be resold for dollars at an increased amount of dollars. In order to profit, however, the pound will have to increase enough to offset the dealer's spread and any commissions

progress had been made on London fixings but that more was needed. Chiara Albanese, *Currencies Trading Needs Further Cleanup, Regulators Say*, WALL ST. J. (N.Y.), Oct. 1, 2015, <http://www.wsj.com/articles/currencies-trading-needs-further-cleanup-regulators-say-1443699941> [<https://perma.cc/8BAP-9PU3>].

251. See *Foreign Exchange Markets and Technology*, CLOANTO, July 7, 2012, <http://currencysystem.com/kb/13-138> (describing the retail tier of the foreign exchange market) [<https://perma.cc/3A5H-ZF8G>].

252. See *What is Forex*, FXCM, <https://www.fxcm.com/forex/what-is-forex/> [<https://perma.cc/3KM2-E8UB>] (last visited May 13, 2015) (describing the dealer's spread).

253. See *id.* (describing how speculators profit).

or fees.

Historically, most foreign exchange dealers required retail customers to pay a much broader so-called “spread” than was available to commercial parties in the interbank foreign exchange market. However, the introduction of electronic trading platforms at the end of the last century resulted in more competition and narrower spreads in both the retail and commercial markets. “While in the 1980s the bid-ask spreads in the over-the-counter market were roughly 20 times those in the inter-dealer market, they have since compressed and are roughly equal.”²⁵⁴ Still, travelers using a bureau de change to convert their currencies will be charged a wider spread than available to direct bank customers and/or a commission.²⁵⁵

Retail cash foreign currency transactions using credit or debit cards also pay a dealer’s spread and are subject to conversion fees charged by the banks issuing the cards. This means that the retail credit or credit card customer receives two hits when converting, because the banks generally use a currency exchange rate less favorable than that available in the commercial interbank market, to which is added the conversion fee. Those charges have been the subject of extended litigation.

A class action lawsuit brought under the Sherman Antitrust Act²⁵⁶ sought damages on behalf of holders of credit cards from Visa, MasterCard, and Diners Club who were charged currency conversion fees between February 1, 1996 and November 8, 2006.²⁵⁷ The plaintiffs claimed that those defendants and their banks conspired to set and conceal currency conversion fees that generally ranged from one to three percent of foreign transactions even when the banks were not exchanging any currency. As a district court described this claim:

[P]laintiffs allege that the procedure VISA and MasterCard use to process all foreign currency transactions, sometimes referred to as ‘netting out,’ often leads to the bulk of foreign currency transactions being conducted without an actual purchase or sale of any foreign currency. Plaintiffs offer the following example: ‘if 100 U.S. VISA cardholders in France charge U.S. \$10,000 in French francs in goods on March 26, 2001, and 100 French VISA cardholders in the U.S. spend the equivalent of U.S. \$10,000 on the same day, defendant VISA does not actually convert any

254. *Sterk v. Bank of America Corp.*, No. 15 CV 2705 Class Action Complaint at ¶¶78-79 (S.D.N.Y. April 7, 2015).

255. See *Exchange Rates*, LONDONFX, <http://www.londonfx.co.uk/exchrate.html> [<https://perma.cc/C433-8QVR>] (last visited May 13, 2015) (describing these differences in spreads and fees).

256. 15 U.S.C. § 1.

257. *In re Currency Conversion Fee Antitrust Litigation*, 265 F. Supp. 2d 385 (S.D.N.Y. 2003).

currency.’ VISA and MasterCard automatically impose this currency conversion fee on the cardholder at the network level.

There are two tranches of currency conversion fees charged by VISA and MasterCard. The first, which plaintiffs label the ‘first tier’ fee, is charged by VISA and MasterCard at an identical 1% of the purchase price. This 1% first tier fee is paid by the cardholder and retained by the respective associations. The ‘second tier’ fee is ‘typically’ two percent (2%), and is often charged on top of the 1% first tier fee. This 2% second tier fee is automatically charged by the network, paid by the cardholder, and retained by the cardholder’s issuing bank.²⁵⁸

The complaint further charged that Visa and MasterCard inflated their exchange rates before applying their currency conversion fees.²⁵⁹ The defendants contended that these claims were subject to arbitration and sought dismissal of the class action claims. The district court required a trial on that issue and that order was affirmed on appeal.²⁶⁰ The plaintiffs claimed damages of some \$3.8 billion,²⁶¹ but the case was subsequently settled for about \$50 million.²⁶²

Credit card charges for cross-border transactions continued to be of concern. MasterCard capped its currency exchange fees in 2009 after it was advised by the European Commission’s competition authority that its fees were too high. In 2015, that same regulator charged MasterCard with charging excessive fees for transactions between countries in the European Union (EU) and for transactions on cards outside the EU.²⁶³

IV. EXCHANGE TRADED FOREIGN EXCHANGE FUTURES

A. *Background*

Commodity futures contracts on agricultural products have been

258. *Id.* at 393-394.

259. *Id.* at 396.

260. *Ross v. Am. Express Co.*, 478 F.3d 96 (2d Cir. 2007).

261. In re Currency Conversion Fee Antitrust Litigation (MDL 1409), <https://www.ccfsettlement.com/faqs/#idQ15> [<https://perma.cc/P2RA-PFZ3>].

262. In re Currency Conversion Fee Antitrust Litigation (MDL 1409), <http://www.ccfsettlement.com/documents/Ross%20v%20Amex%20Preliminary%20Approval%20Motion%20-%20Settlement%20Agreement.pdf> [<https://perma.cc/P76D-D4LN>]

263. *European Antitrust Regulator Accuses MasterCard of Excessive Card Fees*, REUTERS (July 9, 2015), <http://www.reuters.com/article/2015/07/09/eu-antitrust-mastercard-idUSL8N0ZP20T20150709> [<http://www.reuters.com/article/2015/07/09/eu-antitrust-mastercard-idUSL8N0ZP20T20150709>]

traded on exchanges since the Civil War.²⁶⁴ Coincidentally, the breakdown of the Bretton Woods agreement occurred at a time when the futures industry was experimenting with the introduction of derivative instruments that were based on price changes in financial instruments. One such initiative involved the development of a futures market in foreign exchange called the International Monetary Market (IMM). That exchange was boosted by the Nobel Prize winning economist Milton Friedman who supported the creation of such an exchange after his bank refused to allow him to take a short position in the British pound in anticipation of a devaluation of that currency.²⁶⁵ Traders on the IMM also engaged in foreign exchange transactions in the commercial interbank market. Those traders accounted for about 15 percent of volume in the interbank market by 1980.²⁶⁶

B. *The CFTC's Jurisdiction*

Attending these developments was the enactment of the Commodity Futures Trading Commission Act of 1974 (CFTC Act).²⁶⁷ That legislation amended the Commodity Exchange Act of 1936 (CEA). Among other things, the CFTC Act created the Commodity Futures Trading Commission (CFTC). The CFTC replaced the Commodity Exchange Authority, a small bureau in the Department of Agriculture, as the regulator responsible for enforcing the CEA.²⁶⁸ This new agency was thought necessary because the resources of the Commodity Exchange Authority proved inadequate to deal with heavy trading volumes and the expansion of futures trading on financial and other products that occurred during the inflationary period that began in the 1960s.²⁶⁹

The CEA initially applied only to futures contracts on a limited number of agricultural commodities. Several amendments to the CEA over

264. See JERRY W. MARKHAM, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* 2 (1987) (describing the nature and history of commodity futures trading).

265. See MELAMED, *supra* note 137, at 170-177 (describing the development of the International Monetary Market).

266. JULIAN, WAMSLEY, *THE FOREIGN EXCHANGE HANDBOOK* 15 (1983).

267. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974).

268. Under the Commodity Exchange Act of 1936 as it then existed, the Department of Agriculture had day-to-day oversight responsibility for futures trading, which duties were fulfilled by the Commodity Exchange Authority. However, the Commodity Exchange Commission set policy for futures trading under that Act. That commission was composed of the Secretaries of Agriculture, Commerce and the Attorney General. MARKHAM, *supra* note 264, at 27.

269. *Id.* at 55-65. The CFTC is a five member independent federal agency similar to the Securities and Exchange Commission.

the years expanded its reach to other agricultural products on which futures trading had expanded to include. Congress, however, was unable to keep pace with the rapid expansion of futures trading to additional commodities, including non-agricultural commodities, such as gold and silver. The CFTC Act changed the approach of regulation from regulating only certain enumerated commodities to a broader approach of regulating all exchange traded commodity futures, whatever the commodity. The CFTC was given exclusive jurisdiction over all such exchange traded commodity futures and options contracts.²⁷⁰

The CEA requires all futures contracts, with limited exceptions, to be traded on a board of trade that is registered with the CFTC as a “designated contract market” (DCM). One exception to this requirement, the so-called “Treasury Amendment,” that was included in the CFTC Act in order to exclude the commercial interbank foreign exchange market from the CFTC’s jurisdiction. A Senate Report on the CFTC Act noted that: “[a] great deal of the trading in foreign currency in the United States is carried out through an informal network of banks and tellers.”²⁷¹ The report concluded “this market is more properly supervised by the bank regulatory agencies and that, therefore, regulation under this legislation is unnecessary.”²⁷²

The Treasury Amendment stated that the CFTC would have no jurisdiction to regulate “transactions in foreign currency . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade.”²⁷³ As described below, this meant that, unlike other commodities, futures and options on foreign exchange could be traded in the OTC market. As also described below, such OTC trading was beyond the reach of the CFTC until additional legislation was added to allocate jurisdiction among the CFTC, bank regulators and the SEC.

C. *Regulated Futures Contracts on Foreign Currency*

DCMs are required to use a clearinghouse that is registered with the CFTC as a “derivatives clearing organization” (DCO). These DCOs are required to clear and guarantee the performance of futures and options contracts trade on DCMs. The DCOs are required to meet certain core principles such as assuring the sufficiency of their settlement procedures, risk management, system safeguards and default procedures.²⁷⁴

270. *Id.* at 67.

271. S. Rep. No. 93-1131 (1974).

272. *Id.*

273. 7 U.S.C. § 2 (1976).

274. See Jerry W. Markham, *Regulation of Commodity Futures and Exchange Traded*

DCMs are required to police their members to ensure that they comply with the exchange's rules. There are also broad reaching registration and regulatory requirements for industry participants. Those registrants include futures commission merchants (FCMs).²⁷⁵ FCMs act as brokers for customer orders and accept customer funds in connection with those orders. FCMs are subject to a number of regulatory requirements under the CEA. They include financial reporting requirements,²⁷⁶ a minimum net capital requirement,²⁷⁷ a requirement that customer funds be kept segregated²⁷⁸ and extensive recordkeeping requirements.²⁷⁹ Risk disclosure statements must also be given to customers.

These protections do not assure that customers will not lose money in trading exchange regulated foreign currency transactions. In one case, the Second Circuit found that an individual trader lost \$215 million from trading on foreign currency futures over the course of less than five months in 1994-1995.²⁸⁰ The Court ruled in that case that the trader's FCM owed him no fiduciary duty to provide advice and warnings of the dangers of such trades. This was because the trader was wealthy and sophisticated and was aware from experience of the dangers of such trading.²⁸¹

D. *Anti-Manipulation Authority*

The CEA prohibits manipulation²⁸² and certain disruptive trading

Options, Bloomberg/BNA, Securities Practice Portfolio Series, II. (2015) (describing the role and regulation of DCOs).

275. 7 U.S.C. § 6d.

276. 17 C.F.R. § 1.10.

277. 17 C.F.R. §§ 1.12, 1.17.

278. 17 C.F.R. § 1.20.

279. 17 C.F.R. § 1.31.

280. As the Court noted:

In a period of less than five months in 1994-95, plaintiff Henryk de Kwiatkowski ("Kwiatkowski") made and lost hundreds of millions of dollars betting on the U.S. dollar by trading in currency futures. Kwiatkowski traded on a governmental scale: At one point, his positions accounted for 30 percent of the total open interest in certain currencies on the Chicago Mercantile Exchange. After netting over \$200 million in the first trading weeks, Kwiatkowski's fortunes turned; between late December 1994 and mid-January 1995, Kwiatkowski suffered single-day losses of \$112 million, \$98 million, and \$70 million. He continued losing money through the winter. Having lost tens of millions over the preceding several days, Kwiatkowski liquidated all his positions starting on Sunday, March 5 and finishing the next day. In all, Kwiatkowski had suffered net losses of \$215 million.

De Kwiatowski v. Bear Stearns & Co., 306 F.3d 1293, 1295 (2d Cir. 2002).

281. *Id.* at 1308-1309.

282. 7 U.S.C. §§ 9(1), 13(a)(2).

practices, such as wash sales.²⁸³ The anti-manipulation prohibitions contained in the CEA, when it was enacted in 1936, were at the very heart of the effort by Congress to regulate the commodity futures markets. However, the CEA failed to define what it meant by manipulation. It was therefore left to the government and the courts to define the term.²⁸⁴ They came up with a four-part test that requires the following elements to be proved in order to establish an actual commodity price manipulation:

1. the trader had the ability to influence market prices;
2. the trader specifically intended to create an artificial price;
3. an artificial price occurred; and
4. the trader caused the artificial price.²⁸⁵

In an attempted manipulation case, the CFTC has asserted that it need only prove specific intent through some overt act that was intended to be manipulative.²⁸⁶ The elements of manipulation and attempted manipulation are very difficult to prove, especially the specific intent requirement.²⁸⁷ Indeed, while obtaining numerous settlements, the CFTC has won only one adjudicated manipulation case in its forty-year history.²⁸⁸

To ease the burden of proving manipulative intent the Dodd-Frank Act in 2010 amended the CEA to add language borrowed from Section 10(b) of the Securities Exchange Act of 1934 (“34 Act”), which prohibits any “manipulative or deceptive device or contrivance.”²⁸⁹ It was thought that this language would ease the burden of proving manipulative intent because the courts had interpreted it to require only a showing of recklessness.²⁹⁰ However, this is still a very high standard of intent and the

283. 7 U.S.C. § 6c.

284. See Jerry W. Markham, *The Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 YALE J. ON REG. 281 (1991) (describing the background for this legislation and the effects of a lack of definition).

285. Frey v. CFTC, 931 F.2d 1171, 1175 (7th Cir. 1991).

286. In the Matter of Hohenberg Bros., Comm. Fut. L. Rep. (CCH) ¶20, 271, n. 41 (C.F.T.C. 1977).

287. JERRY W. MARKHAM, LAW ENFORCEMENT AND THE HISTORY OF FINANCIAL MARKET MANIPULATION (2014) (describing the difficulty of proving manipulation charges).

288. In the Matter of DiPlacido, Comm. Fut. L. Rep. ¶30,970 (C.F.T.C. 2008), *aff’d sub nom.*, DiPlacido v. CFTC, No. 08-5559-ag, 2009 U.S. App. LEXIS 22692 (2d Cir. 2009), *cert denied*, 2010 U.S. LEXIS 2461 (2010).

289. 15 U.S.C. §78j(b).

290. See, e.g., South Cherry St., LLC v. Hennessee Group LLC, 573 F.3d 98, 109-110 (2d Cir. 2009) (noting that the Second Circuit has long held that reckless disregard for the truth satisfies the scienter element of a securities fraud action); Robert N. Clemens Trust v. Morgan Stanley DW Inc., 485 F.3d 840, 847 (6th Cir. 2007) (noting that the Sixth Circuit has long held reckless behavior satisfies the scienter element of a securities fraud action); Sundstrand Corp. v. Sun Chemical Corp., 553 F. 2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977) (interpreting the scienter element of a securities fraud action as

difference between that standard and the specific intent required under the pre-Dodd-Frank anti-manipulation authority may be only slight.²⁹¹

A class action lawsuit was filed in the wake of the interbank foreign exchange market scandals that are described above. That follow-on suit charged that the twelve large banks involved in the London Fix manipulations were also manipulating regulated foreign exchange futures contracts that were traded on two regulated DCMs.²⁹² The complaint charged violations of the Sherman Antitrust Act and violations of the anti-manipulation provisions of the CEA and CFTC rules.²⁹³ That litigation was pending as of the date of this writing.

E. *Exchange Traded Foreign Exchange Options*

The CFTC allowed the trading of foreign currency options on regulated DCMs, but the SEC challenged the CFTC's otherwise broad exclusive jurisdiction over exchange-traded derivatives with respect to the trading of options on foreign currencies. In 1973, the creation of the Chicago Board Options Exchange, Inc. (CBOE) laid the groundwork for that regulatory competition. Created by a futures exchange, the CBOE traded options on stock in a manner used by the commodity futures exchanges.²⁹⁴ The SEC assumed jurisdiction over that exchange because options on stock had been traditionally within its jurisdiction. The creation of the CBOE also predated the CFTC Act of 1974, and at that time the CEA did not then cover futures or options on financial instruments.

As the Seventh Circuit noted in resolving a jurisdictional dispute between the SEC and the futures exchange that created the CBOE:

The CBOE itself, the nation's first central market for securities options, evolved from an effort by the Chicago Board of Trade in the late 1960's to develop *futures contracts* in securities. At that time, however, such activity did not fall within the Commodity Exchange Act, the statute governing other Chicago Board of Trade activity. As a result, the plan was modified to qualify it as

a recklessness standard).

291. See MARKHAM, *supra* note 287 at § 8:2 (describing further why the two standards may vary only slightly).

292. Robert Mackenzie Smith, CME Forex Fix Questioned in New Lawsuit, RISK.NET (May 8, 2015), <http://www.risk.net/risk-magazine/news/2407756/cme-forex-fix-questioned-in-new-lawsuit> [https://perma.cc/3GYR-R7EA].

293. *Sterk v. Bank of America Corp.*, No. 15 CV 2705 Class Action Complaint (S.D.N.Y. April 7, 2015).

294. See generally Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALBANY L. REV. 741 (1983) (detailing the creation of the CBOE).

an options program under the Federal securities laws. Had the plan emerged after the 1974 amendments to the Commodity Exchange Act, when the term “commodity” was broadened to encompass securities and the CFTC was awarded exclusive regulatory jurisdiction, the Chicago Board of Trade could have retained its original objective of trading securities *futures contracts* on its own floor under the same statute—the Commodity Exchange Act—governing its other activities. The divergence of securities options trading from futures trading was fortuitous, therefore, due to a state of the law at the time that no longer applies.²⁹⁵

The SEC began squabbling over the scope of the CFTC’s exclusive jurisdiction over options and futures on financial instruments soon after the creation of the CFTC. The SEC was unsuccessful in curbing the CFTC’s regulation of derivative financial instruments. The respective chairmen of the two agencies then reached an agreement delineating their respective roles.²⁹⁶ That agreement was included in the Futures Trading Act of 1982.²⁹⁷ Among other things, that legislation gave the SEC jurisdiction over trading in foreign exchange on national securities exchanges registered with that agency. The CFTC retained exclusive jurisdiction over options and futures on foreign exchange conducted on contract markets regulated by the CFTC.²⁹⁸ Trading in options on several foreign currencies was undertaken by various exchanges, and Nasdaq continues to trade options on currencies.²⁹⁹

V. THE RETAIL OTC DERIVATIVES MARKET

A. SEC and CFTC Jurisdiction

Another provision in the CFTC Act gave the CFTC exclusive jurisdiction over most commodity options. Previously, the CEA had, because of abuses, prohibited options trading on the agriculture commodities regulated by that statute.³⁰⁰ Nevertheless, trading in options

295. Board of Trade of Chicago v. SEC, 677 F.2d 1137, 1140, n. 2 (7th Cir. 1982).

296. See Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 569-571 (2009) (describing the turf wars between the agencies).

297. Pub. L. No. 97-444, 96 Stat. 2294 (1982).

298. See Jerry W. Markham, *Super-Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, Great Britain & Japan*, 28 BROOK. J. INT’L L. 319, 360, n. 210 (2003) (describing this jurisdictional division).

299. *Nasdaq Spot FX Options*, <http://www.nasdaq.com/investing/forex/spot-fx-options.aspx> [https://perma.cc/6BNK-TVNB] (last visited May 13, 2015).

300. 7 U.S.C. § 6c (1936).

on unregulated commodities had become popular in the 1970s. That trading was fueled by inflation that encouraged speculation through options trading on precious metals and in foreign exchange after the breakdown of the Bretton Woods agreement. A number of scandals arose in the sale of those options to the public just before the creation of the CFTC. The SEC stepped in and charged that those options were securities regulated under the federal securities laws.³⁰¹

The SEC's action stopped much of this fraud, but the CFTC Act removed jurisdiction from the SEC over commodity options and granted the CFTC exclusive jurisdiction over those instruments.³⁰² That was not, at least initially, a good choice because the CFTC had no regulations in place to govern such trading and little staff to administer such regulations. The result was a resurgence of fraud by firms marketing OTC commodity options. The CFTC then tried to adopt regulations to strictly regulate OTC commodity option sales, but that action came too late to stop the widespread fraudulent sale of these instruments.³⁰³ In one famous case it was discovered that an escaped felon ran one of the largest fraudulent operations.³⁰⁴ The CFTC then acted to suspend all retail commodity option sales in 1978, but later allowed exchange traded options that could be closely regulated.³⁰⁵

B. CFTC Jurisdiction

The CFTC's actions did not stop fraud in OTC foreign exchange instruments. Those OTC dealers simply styled their instruments as cash or forward contracts that were outside the CFTC's jurisdiction. The CFTC responded with actions charging that these were actually disguised futures or options that had to be traded on a regulated exchange. The CFTC was successful in several actions involving OTC transactions in bullion and other commodities, but frauds continued to proliferate.³⁰⁶ Disaster struck in 1983, after J. David & Co. was discovered to be running a foreign exchange Ponzi scheme in San Diego that took in some \$200 million from

301. See Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 17, n. 61 (1994) (describing those events).

302. 7 U.S.C. § 6c (1970) (amended 1974).

303. See Markham & Gilberg, *supra* note 296, at 763-66 (describing these regulations and events).

304. See Markham, *supra* note 116, at 54-55 (describing that scandal).

305. Exempted from that ban were commercial or trade options that did not involve the public. Markham & Gilberg, *supra* note 296, at 766-68.

306. See, e.g., CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 566 (9th Cir. 1982) (prosecuting OTC bullion dealer for selling illegal OTC futures).

many prominent individuals in that city. The owner of the firm, J. David Dominelli, a.k.a. “Captain Money,” promised investors returns of 40 percent from foreign currency trades that were supposedly made in the interbank foreign exchange market that was outside the jurisdiction of the CFTC.³⁰⁷ Dominelli received a twenty-year prison sentence, but was released after ten.³⁰⁸

The CFTC tried to close the Treasury Amendment loophole in 1985 through a proposed interpretation of that provision that would exclude from its reach foreign exchange transactions involving members of the public. The CFTC proposal asserted that the Treasury Amendment applied only to banks and large commercial institutions.³⁰⁹ That proposal encountered a storm of criticism when it was published for comment, and it was tabled.³¹⁰ Nevertheless, the CFTC continued to claim in its enforcement cases that the Treasury Amendment did not apply to foreign exchange transactions in futures or options traded in the OTC market. That assertion resulted in a split among the courts that the Supreme Court was called upon to resolve.

The Fourth Circuit held in *Salomon Forex, Inc. v. Tauber*³¹¹ that futures and options on foreign exchange were excluded from the CFTC’s jurisdiction by the Treasury Amendment. The Court noted that:

Interpretations of the Treasury Amendment have varied with the role of the interpreter. The Commodity Futures Trading Commission, pressing for greater regulation of transactions in foreign currencies, contends that the Treasury Amendment’s exemption is intended to be narrowly tailored to exclude only spot and cash forward transactions, leaving all other futures and options to be regulated by the broad inclusive regulatory language of the Act. Foreign currency traders and the United States contend that off-exchange trades must not be burdened by regulation, and the plain meaning of the Treasury Amendment expressly so provides.³¹²

The Court concluded, however that “the appropriate interpretation of the

307. See DONALD BAUDER, CAPTAIN MONEY AND THE GOLDEN GIRL: THE J. DAVID AFFAIR (1985) (describing this Ponzi scheme).

308. Nate Rawlings, *Top 10 Swindlers*, TIME, Mar. 7, 2012, http://content.time.com/time/specials/packages/article/0,28804,2104982_2104983_2105003,00.html [<https://perma.cc/CU4B-3RWU>].

309. CFTC, Trading in Foreign Currencies for Future Delivery, 50 Fed. Reg. 42,983 (Oct. 23, 1985).

310. See Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives*, 1990 COLUM. BUS. L. REV 1, 9-10 (1990) (describing this controversy).

311. 8 F.3d 966 (4th Cir. 1993).

312. *Id.* at 974-975.

Treasury Amendment, all off-exchange transactions in foreign currency, including futures and options, are exempted from regulation by the CEA.”³¹³

The Second Circuit took the opposite approach and agreed with the CFTC’s position that such instruments were outside the reach of the Treasury Amendment.³¹⁴ The Supreme Court granted a writ of certiorari in that case in order to resolve the circuit split.³¹⁵ The Supreme Court held in *Dunn v. CFTC*³¹⁶ that the Treasury Amendment excluded the CFTC from regulating off exchange trading in options to buy foreign currency. That ruling served to encourage the continuation of widespread fraud in retail OTC futures and options on currencies.³¹⁷

C. *The CFMA*

After its defeat in the *Dunn* case, the CFTC sought legislation from Congress that would allow it to regulate dealers selling retail foreign exchange futures or options. Congress included such authority in the Commodity Futures Modernization Act of 2000 (CFMA).³¹⁸ That legislation amended the CEA to prohibit the sale of retail OTC futures or options contracts unless the party offering the transaction was a financial institution, a broker-dealer registered with the SEC, a futures commission merchant (FCM) registered with the CFTC, an insurance company or its affiliates, a regulated financial holding company or an investment bank holding company.³¹⁹

The theory behind this legislation was to eliminate the unregulated, fly-by-night, fraudulent operations marketing OTC foreign exchange

313. *Id.* at 976.

314. *CFTC v. Dunn*, 58 F.3d 50 (2d Cir. 1995).

315. *Dunn v. CFTC*, 517 U.S. 1219 (1996).

316. 519 U.S. 465 (1997).

317. For example, in *New York Currency Research Corp. v. CFTC*, 180 F.3d 83 (2d Cir. 1999), the respondent terminated its registration as a commodity trading advisor and commodity pool operator with the CFTC after the Supreme Court’s decision in *Dunn*. The respondent then refused to respond to CFTC requests for information about its currency trading operations. The Second Circuit held that the respondent did not need to comply with the information requests because it was exempt from CFTC regulation.

318. Pub. L. No. 106-554, 114 Stat. 2763, § 102 (2000).

319. 7 U.S.C. §2(c)(2)(B) (2000). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 amended this list by removing insurance companies and financial and investment bank holding companies from the approved providers. In addition, Dodd-Frank required financial institutions offering these products to be U.S. based. *See* Jerry W. Markham, *Regulation of Swap and Other Over-The-Counter Derivative Contracts*, Bloomberg/BNA Securities Practice Portfolio Series No. 263, at p. A-50 (2014) (describing effects of the Dodd-Frank legislation).

futures and options. In their stead, only highly regulated entities with substantial capital were allowed to sell those products. Congress also allowed “eligible contract participants” to trade foreign exchange options and futures with each other because those large institutions or wealthy individuals were not viewed to need regulatory protection.³²⁰

Unfortunately, the CFMA left a gaping hole through which the fraudsters could continue their operations. The prohibitions in the CFMA applied only to futures and options and not to spot or forward contracts where delivery of the currency was called in the party’s contracts. The scope of this loophole became clear in *CFTC v. Zelener*,³²¹ a decision rendered by the Seventh Circuit in 2004. In *Zelener*, the defendants were selling foreign exchange as a principal to retail investors under contracts that were to be settled within forty-eight hours of the sale. In fact, delivery and payment rarely occurred. Instead, the contracts were rolled over continually until the customer decided to recognize a gain or loss on the position. That recognition was done through a cash settlement for the amount of the gain or loss. The dealer never owned any foreign currency, and no customer ever took delivery of any foreign currency. Nevertheless, a customer could have demanded delivery, and the dealer would have been obligated under its contract with the customer to make the delivery.³²²

The Seventh Circuit held in *Zelener* that these were not futures contracts that were subject to retail foreign exchange provisions added by the CFMA. The Court noted that the contracts were not standardized and could not be traded on an exchange. Moreover, the contracts called for actual delivery. The Court held that the fact that delivery was never made did not mean that the obligation was not a cash contract.³²³ The decision in *Zelener* was followed by the Sixth Circuit in a case involving retail foreign currency contracts on which no delivery was ever taken. There, the Sixth Circuit held that even though it was only “pretend” trading, the transactions were not futures subject to CFTC regulation.³²⁴

The loophole recognized by these decisions proved to be a costly one.

320. See *CFTC v. Zelener*, 373 F.3d 861, 862-863 (7th Cir. 2004) (describing those persons and reason for exemption).

321. *Id.*

322. *Id.* at 863.

323. *Id.* at 869. This approach of looking to the contract terms, rather than the actual practices of the parties, had been previously used by the Supreme Court to distinguish futures contracts from gambling operations. The Supreme Court held in those cases that futures trading was not gambling because, even though the parties rarely took delivery, the contracts when initiated required delivery of the underlying commodity. *Board of Trade of City of Chicago v. Christie Grain & Stock Co.*, 198 U.S. 236 (1905); *Bibb v. Allen*, 149 U.S. 481 (1893); *Hansen v. Boyd*, 161 U.S. 397 (1896).

324. *CFTC v. Erskine*, 512 F.3d 309, 312 (6th Cir. 2008).

Between 2001 and 2007 it was estimated that some 26,000 investors were defrauded out of over \$460 million as the result of foreign exchange trading scams using OTC derivatives.³²⁵ The CFTC went so far as to issue a public warning to consumers in both English and Spanish about this widespread fraud.³²⁶ The CFTC also brought dozens of enforcement actions but was continuously thwarted by the *Zelener* decision.³²⁷

325. Jerry W. Markham, A FINANCIAL HISTORY OF THE UNITED STATES FROM ENRON-ERA SCANDALS TO THE SUBPRIME CRISIS (2004-2006) 195 (2011).

326. CFTC No. 4127-98 CONSUMER ADVISORY ON FOREIGN CURRENCY TRADING (Mar. 30, 1998). *See also*, CFTC FOREIGN EXCHANGE CURRENCY FRAUD: CFTC/NASAA INVESTOR ALERT, <http://www.cftc.gov/consumerprotection/fraudawarenessprevention/foreigncurrencytrading/cftcnasaaforexalert> (detailing the widespread fraudulent transactions). This advisory described how these scams work:

Forex scams attract customers with sophisticated-sounding offers placed in newspaper advertisements, radio promotions, or on Internet sites. Promoters often lure investors with the concept of leverage: the right to “control” a large amount of foreign currency with an initial payment representing only a fraction of the total cost. Coupled with predictions about supposedly inevitable increases in currency prices, these contracts are said to offer huge returns over a short time, with little or no downside risk.

In a typical case, investors may be assured of reaping tens of thousands of dollars in just a few weeks or months, with an initial investment of only \$5,000. Often, the investor’s money is never actually placed in the market through a legitimate dealer, but simply diverted—stolen—for the personal benefit of the con artists.

Id.

327. The CFTC was able to obtain default or consent judgments and ex parte restraining orders in numerous cases. *See, e.g.*, CFTC v. UFOREX Consulting, LLC, Comm. Fut. L. Rep. (CCH) ¶30,431 (W.D. La. 2006) (ordering a statutory restraining order against defendant); CFTC v. Intertrade Forex, Inc., Comm. Fut. L. Rep. (CCH) ¶30,022 (M.D. Fla. 2005) (ordering default judgment for the CFTC); CFTC v. Richmond Global Associates, LLC, Comm. Fut. L. Rep. (CCH) ¶30,027 (S.D.N.Y. 2005) (ordering an ex parte statutory restraining order freezing defendant’s assets); CFTC v. Premium Income Corp., LLC, Comm. Fut. L. Rep. (CCH) ¶30,036 (N.D. Tex. 2005) (ordering an ex parte statutory restraining order freezing defendant’s assets and permitting expedited discovery); CFTC v. Sonoma Trading Corp., Comm. Fut. L. Rep. (CCH) ¶30,038 (S.D. Fla. 2005) (ordering an ex parte statutory restraining order freezing defendant’s assets and permitting expedited discovery); CFTC v. Ouyang, Comm. Fut. L. Rep. (CCH) ¶30,043 (C.D. Cal. 2005) (ordering a permanent injunction and ancillary relief); CFTC v. Emerald Worldwide Holdings, Inc., Comm. Fut. L. Rep. (CCH) ¶30,055 (C.D. Cal. 2005) (ordering default judgment for the CFTC); CFTC v. G7 Advisory Services, LLC, Comm. Fut. L. Rep. (CCH) ¶30,056 (S.D. Fla. 2005) (ordering an ex parte statutory restraining order freezing defendant’s assets and permitting expedited discovery); CFTC v. Presidential FX, Inc., Comm. Fut. L. Rep. (CCH) ¶30,115 (E.D. Va. 2005) (ordering a preliminary injunction enjoining defendant’s activities and other equitable relief); CFTC v. National Investment Consultants, Inc., Comm. Fut. L. Rep. (CCH) ¶30,109 (N.D. Cal. 2005) (ordering an ex parte statutory restraining order freezing defendant’s assets and permitting expedited

D. *More Legislation*

In the face of this crime wave, and after the stinging defeat in *Zelener*, the CFTC sought and obtained additional legislation to reverse its effects. The so-called “*Zelener* fix”³²⁸ was added to the CEA by the CFTC Reauthorization Act of 2008 (Reauthorization Act of 2008).³²⁹ This fix gave the CFTC regulatory authority over leveraged retail foreign exchange contracts regardless of whether they are options or futures.³³⁰ However, this authority did not extend to “the large, sophisticated interbank market or to place additional requirements on businesses with a need to engage in forex transactions in connection with their legitimate business activities.”³³¹

The Reauthorization Act of 2008 authorized the CFTC to expand its regulation of existing registrants that sell retail foreign exchange on a leveraged basis. Those registrants included FCMs, commodity pool operators and commodity trading advisors. A new category of registrant was also created, *i.e.*, retail foreign exchange dealers (RFEDs), who were allowed to traffic in such transactions. These firms were required to have a minimum capital of ten million dollars, which was increased to twenty million dollars in 2009. FCMs selling these products were also subjected to that capital requirement.³³²

discovery); *CFTC v. International Currency Exchange, Inc.*, Comm. Fut. L. Rep. (CCH) ¶30,147 (S.D.N.Y. 2005) (ordering an *ex parte* statutory restraining order freezing defendant’s assets and permitting expedited discovery). *See also*, JERRY W. MARKHAM, COMMODITIES REGULATION FRAUD, MANIPULATION & OTHER CLAIMS §27:14.30 (2014) (describing numerous other such cases).

328. *See Hearing to Review Implications of the CFTC v. Zelener Case Before the Subcomm. on Gen. Farm Commodities and Risk Mgmt. of the Comm. on Agric.*, 111th Cong. (2009) (describing limitations of the “*Zelener* fix”), <http://www.gpo.gov/fdsys/pkg/CHRG-111hhr52664/html/CHRG-111hhr52664.htm> [<https://perma.cc/47A7-L9FV>].

329. That statute was contained in the Food Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651 (2008).

330. *See* CFTC, Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries, 75 Fed. Reg. 3281, 3285 (Jan. 20, 2010) (describing the effects of this amendment).

331. *Id.*

332. *See* 17 C.F.R. §§ 1.12, 1.17 (describing capital requirement for FCMs). The CFTC has settled several cases brought against RFEDs for minimum capital violations. *See e.g.*, FXDirect Dealer, LLC, No. 14-28, 2014 WL 4793547 (C.F.T.C. 2014) (ordering administrative proceedings where FX exchange dealer consented to findings of net capital violations); Global Futures and Forex, Ltd., No. 14-17, 2014 WL 2121432 (C.F.T.C. 2014) (ordering administrative proceedings where the net capital violation of a jointly registered FCM/RFED on an unconsolidated basis was found by consent); IBFX, Inc., No. 15-10, 2014 WL 6988892 (C.F.T.C. 2014) (ordering administrative proceedings where net capital violations by an FX dealer were found by consent); Capital Market Services, LLC, No. 14-12, 2014 WL 1401405 (C.F.T.C. 2014) (same).

These new requirements created an incentive for retail foreign exchange dealers to move their operations to SEC regulated broker-dealers, which were not subject to CFTC oversight. This caused the Financial Industry Regulatory Authority (FINRA), the securities industry self-regulatory body, to issue a regulatory notice that advised broker-dealers engaging in retail foreign exchange that such business was subject to its rules. This notice pointed out that:

The primary forex market is the interbank market, in which large banks, financial institutions and other eligible participants trade currencies amongst themselves. In recent years, however, an electronic, secondary over-the-counter (OTC) market has developed. Retail customers participate in the secondary OTC market with retail dealers, albeit typically at different prices and with higher spreads than those that occur in the interbank market.³³³

FINRA also warned of the dangers presented to retail customers by these instruments:

The currency market is extremely volatile and retail forex customers are exposed to substantial currency risk. Some currencies are significantly more volatile than others. Many forex dealers extend leverage to their customers at ratios of 400:1 or higher, which allows customers to control contracts worth significantly more than their cash investment. The high leverage ratios magnify even minor fluctuations in currency rates, exponentially increasing a customer's losses and gains. Even a small move against a customer's position can result in a significant loss. Unlike margin in a securities account, forex customers are typically closed out of their position once their loss exceeds their initial investment. However, if, for any reason, the position is not closed out at a zero *balance*, *the customer could be liable for additional losses*.³³⁴

The FINRA notice stated that broker-dealers participating in the retail foreign exchange market were subject to applicable FINRA rules.³³⁵ Those rules require broker-dealers to comply with "just and equitable principles of trade."³³⁶ Among other things, those rules require a disclosure of the risks of trading foreign currency and the effects of leverage. Those

333. FINANCIAL INDUSTRY REGULATORY AUTHORITY, REGULATORY NOTICE 08-66: RETAIL FOREIGN CURRENCY EXCHANGE (Nov. 2008).

334. *Id.*

335. *Id.* (emphasis added).

336. FINANCIAL INDUSTRY REGULATORY AUTHORITY, RULE 2010: STANDARDS OF COMMERCIAL HONOR AND PRINCIPLES OF TRADE.

principles also prohibit false, exaggerated, unwarranted or misleading communications with the public, which include projections or predictions of profit or that past performance will recur.³³⁷

E. *The Dodd-Frank Act*

The next legislative step was to clarify jurisdiction over retail OTC foreign exchange trading on a leveraged basis and without actual delivery. This was done through the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).³³⁸ That act divided jurisdiction over these instruments among the CFTC, SEC, and banking regulators. Those agencies then adopted rules to implement this authority.³³⁹

The CFTC promulgated a number of rules under Dodd-Frank for retail OTC foreign exchange transactions.³⁴⁰ Those rules did not apply to commercial trading in the interbank foreign exchange market, to transactions between large commercial or financial institutions known as eligible contract participants (ECPs), or to foreign exchange options or futures trading on regulated commodity exchanges. To prevent evasion, commodity pools were not allowed to claim ECP status if they directly enter into retail foreign currency transactions with retail customers and have one or more direct participants that are not ECPs.³⁴¹

Among other things, the CFTC rules prohibit fraud,³⁴² require that investors in these transactions be given a prescribed risk disclosure statement,³⁴³ continue to require minimum adjusted net capital for dealers of at least twenty million dollars,³⁴⁴ continue minimum margin requirements,³⁴⁵ require risk assessments by dealers³⁴⁶ and set trading and operational standards.³⁴⁷ Dealers were required to register with the industry self-regulatory body, the National Futures Association (NFA), and be

337. See *supra* note 335 (explaining the notice).

338. Pub. L. No. 111-203, 124 Stat 1376-2223 (2010).

339. See Markham, *supra* note 327 (describing this legislation and the rules adopted by the regulators under its provisions).

340. 17 C.F.R. § 5.1.

341. Further Definition of “Swap Dealer,” “Security- Based Swap Dealer,” “Major Swap Participant,” “Major Security- Based Swap Participant” and “Eligible Contract Participant,” Exchange Act Release 34-66868 77 Fed. Reg. 30,596, 30,646–647 (May 23, 2012).

342. 17 C.F.R. § 5.2 (2015).

343. 17 C.F.R. § 5.5 (2015).

344. 17 C.F.R. §§ 5.6, 5.7 (2015).

345. 17 C.F.R. § 5.9 (2015).

346. 17 C.F.R. §§ 5.10 & 5.11 (2015).

347. 17 C.F.R. § 5.18 (2015).

subject to its rules.³⁴⁸

The NFA had previously adopted rules governing OTC trading in retail foreign exchange transactions by its members.³⁴⁹ Those transactions were defined in NFA rules as OTC foreign exchange transactions that are entered into on a leveraged or margin basis and that do not involve large institutions identified as ECPs, transactions where actual delivery of currency is made within two days or where a forward contract requires actual delivery between two parties having the ability to make or take delivery.

NFA rules, among other things, require its members to “observe high standards of commercial honor and just and equitable principles of trade”³⁵⁰ This prohibition extends to fraudulent conduct and requires diligent supervision of employees marketing retail foreign currency.³⁵¹ Marketing materials for retail foreign currency transactions are subject to review by the NFA.³⁵² Financial information on dealers is required to be submitted to the NFA.³⁵³ Dealers are also required to warn customers that in the event of the dealer’s insolvency there would be no account insurance and the customer would be treated only as a general creditor.³⁵⁴

In August 2015, the CFTC approved amendments to NFA rules that sought to enhance protections for retail foreign exchange customers dealing with NFA Forex Dealer Members (FDMs). The CFTC described those amendments as:

- (1) imposing additional capital requirements on FDMs; (2) requiring FDMs to collect security deposits for off-exchange foreign currency transactions from eligible contract participant counterparties in addition to retail counterparties; (3) requiring FDMs to adopt and implement rigorous risk management programs; and (4) requiring FDMs to provide additional market disclosures and firm-specific information on their websites to permit current and potential counterparties to better assess the risks of engaging in off-exchange foreign currency transactions

348. 17 C.F.R. § 5.22 (2015).

349. NATIONAL FUTURES ASSOCIATION, *FOREX TRANSACTIONS: A REGULATORY GUIDE*, BYLAW 1057 (Feb. 13, 2007). NFA rules governed the marketing and other practices of its members. However, retail foreign currency dealers that are not registered with the CFTC as a FCM were not required to be members.

350. NATIONAL FUTURES ASSOCIATION, *FOREX TRANSACTIONS: A REGULATORY GUIDE*, RULE 2-36 (2011).

351. *Id.*

352. *Id.*

353. NATIONAL FUTURES ASSOCIATION, *FOREX DEALER MEMBER REQUIREMENTS FOR WEEKLY FOREX REPORTS AND BANKRUPTCY DISCLOSURE*, NFA NOTICE TO MEMBERS I-06-13 (Aug. 1, 2006).

354. *Id.*

and with conducting business with a particular FDM.³⁵⁵

The SEC adopted a rule that subjected retail foreign exchange transactions to its existing rules and to those of FINRA, where the dealer was a registered broker-dealer.³⁵⁶ The SEC, noted, however, that transactions in which the currency was actually delivered within two days and forward transactions involving actual delivery would not be retail foreign exchange transactions subject to its regulation.³⁵⁷

The Federal Reserve Board (Fed) also adopted rules allowing banks to engage in retail foreign exchange transactions. Among other things, those rules require member banks to be well capitalized,³⁵⁸ and they must notify the Fed if they offer such products.³⁵⁹ Fraud is prohibited,³⁶⁰ and customers are required to be given a prescribed risk disclosure statement that discloses the percentage of customers losing and making money in retail foreign currency transactions through the bank.³⁶¹ A minimum margin of two percent of the notional amount of retail foreign exchange transactions was imposed for major currencies and five percent for other currencies.³⁶²

The Office of the Comptroller of the Currency (OCC) adopted rules for retail foreign exchange transactions that largely tracked those of the Fed.³⁶³ The OCC required banks offering these products to first obtain its permission to do so.³⁶⁴ The FDIC adopted a similar regulatory framework.³⁶⁵

VI. FUNCTIONAL REGULATION BREAKDOWN

A. *Functional Regulation*

The United States has developed a *functional* system for the regulation of financial services. This regulatory structure seeks to assure that the

355. Press Release, CFTC Approves National Futures Association Rules Enhancing Protections for Retail Forex Customers (Aug. 27, 2015), <http://www.cftc.gov/PressRoom/PressReleases/pr7219-15> [<https://perma.cc/28EM-6G7Q>].

356. 17 C.F.R. § 240.15b12-1 (2014). This rule stated that it would expire on July 31, 2016, which provides the SEC an opportunity to assess its effects before renewing it. *Id.*

357. *Id.*

358. 12 C.F.R. § 240.8 (2015).

359. 12 C.F.R. § 240.4 (2015).

360. 12 C.F.R. § 240.3 (2015).

361. 12 C.F.R. § 240.6 (2015).

362. 12 C.F.R. § 349.9 (2012).

363. 12 C.F.R. § 48.1 (2014).

364. Office of the Comptroller of the Currency (OCC), Retail Foreign Exchange Transactions, 76 Fed. Reg. 41, 375 (July 14, 2011).

365. 12 C.F.R. § 349.1 (2014).

same financial product is regulated by a designated regulator wherever the product is traded. Functional regulation thus seeks to compartmentalize particular financial services activities into regulatory boxes that do not overlap. For example, the SEC is assigned the role of regulating the securities markets, the CFTC is tasked with regulating commodity futures and options markets, and bank regulators, such as the Federal Reserve Board and the Comptroller of the Currency, are given the responsibility for regulating the business of banking.³⁶⁶

There have been some deviations from the functional regulation model in the U.S. For example, the Securities Exchange Act of 1934 was amended in 1975 to impose regulation by the SEC over the clearing, settlement and transfer of stocks in the securities market.³⁶⁷ That legislation was accompanied by a turf war with the bank regulators who did not want the SEC regulating bank clearing and settlement activities.³⁶⁸ A compromise was reached in which stock clearing, settlements and transfers engaged in by banks would be regulated by the “appropriate regulatory agency.”³⁶⁹ The “appropriate regulatory agency” was allowed to adopt and enforce its own rules governing clearing and transfer of stock.³⁷⁰ However, a slight nod was given to functional regulation through requirements that the SEC and the appropriate regulatory consult and cooperate with each other and give each other advance notice of proposed rules governing clearing and transfers.³⁷¹

The Government Securities Act of 1986 was another step away from functional regulation.³⁷² That legislation subjected non-banks acting as dealers in government securities to regulation by the SEC. However, financial institutions, such as banks, were placed outside the SEC’s reach. Instead, financial institutions became subject to regulation by the “appropriate regulatory agency.”³⁷³ The Treasury Department was tasked

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

367. 15 U.S.C. § 78q-1 (2010). The Securities Exchange Act defines a clearing agency as a person acting as an intermediary in making payments or deliveries of securities transactions or who compares data concerning the settlement of securities transactions. The definition also includes custodians or depositories of securities at a central location. 15 U.S.C. § 78c(a)(24) (2010).

368. At that time, there were some 800 bank transfer agents and some 2,700 non-bank transfer agents. See JERRY W. MARKHAM, *BROKER DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION, AND CUSTOMER PROTECTION* § 13:2 (2014) (describing this jurisdictional fight).

369. 15 U.S.C. § 78q-1.

370. *Id.*

371. *Id.*

372. Pub. L. No. 99-571, 100 Stat. 3208 (Oct. 28, 1986).

373. 15 U.S.C. § 78o-5.

with adopting rules to govern the operations of government securities dealers and brokers.³⁷⁴ Those rules were to address the financial responsibility, protection of customer securities and balances, recordkeeping and reporting of brokers and dealers in government securities.³⁷⁵

The Treasury Department largely adopted SEC broker-dealer rules as the basis for the protection of customer funds associated with trading in government securities.³⁷⁶ This seemed to be an effort to preserve functional regulation by using the same or similar regulation for the same product but deviated from that principle by employing more than one regulator to regulate the same function, using different rules. For example, the Treasury Department's capital rule allowed government securities broker-dealers registered with the SEC to comply with the SEC's capital rule and financial institutions to comply with bank regulator capital requirements.³⁷⁷ That was a deviation from functional regulation because those capital computations were quite different in approach.³⁷⁸

The passage of the Gramm-Leach-Bliley Act (GLB) in 1999 was another blow to functional regulation.³⁷⁹ GLB repealed the Glass-Steagall Act of 1933, which had tried to define and limit the business of banking to the acceptance of deposits and making loans.³⁸⁰ However, the Glass-Steagall barriers were gradually breached over a period of several decades as banks sought to expand their financial services into the securities and other financial markets. Those actions were often challenged in court, but the banks continued their relentless efforts to expand their financial services into the securities and other markets.³⁸¹ Congress finally threw in the towel in 1999 with the passage of GLB.

374. 15 U.S.C. § 78o-5 (b).

375. See 17 C.F.R. §§ 400.1 (2006) (outlining Treasury Department Regulations for government securities dealers and brokers).

376. See, e.g., 17 C.F.R. § 403.4 (implementing broker-dealer rules in this fashion).

377. 17 C.F.R. § 402.1 (2014).

378. For a time, the SEC allowed certain broker-dealers that were a part of a consolidated supervised entity to use the Basel Committee's capital requirement. However, those firms either failed (e.g., Lehman Brothers) or became banks (Morgan Stanley and Goldman Sachs) or were acquired by banks (Merrill Lynch) during the Financial Crisis in 2008, and that provision was repealed. See JERRY W. MARKHAM, *BROKER DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION, AND CUSTOMER PROTECTION* §4:42.50 (2014) (describing that rule and its failure).

379. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999).

380. Banking Act of 1933, Ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (June 16, 1933).

381. See also Jerry W. Markham, *The Subprime Crisis—A Test Match for the Bankers*, 12 U. PENN. L. & BUS. J. 1081, 1095, 1103 (2010) (describing those cases).

There was an effort to preserve at least some aspects of functional regulation in GLB by requiring banks to push their securities business out of the bank and into an affiliated broker-dealer that would be regulated by the SEC.³⁸² Nevertheless, a number of securities market activities were carved out of these “push out” requirements. This allowed the bank itself to conduct those activities without regulation by the SEC. Those activities included transactions in U.S government securities, trust investment activities, municipal bond transactions, certain transactions in asset backed debt, commercial paper, dividend reinvestment plans, sweep accounts, stock purchase plans and stock custody arrangements.³⁸³ This push out meant that those activities would not be regulated functionally.

More slippage in functional regulation occurred with the enactment of the CFMA in 2000.³⁸⁴ The SEC and CFTC set the boundaries of their respective jurisdictions in 1982 based only somewhat on functional regulation grounds, foreign currency being a deviation from that principle.³⁸⁵ At that time, the two agencies could not agree on who should regulate futures on single stocks, for example IBM. As a result of that disagreement, trading on such instruments was prohibited until the enactment of the CFMA in 2000. The CFMA deviated from the functional regulation approach by allowing trading in single stock futures on both commodity and stock exchanges, separately regulated respectively by the CFTC and SEC. The place of its trading, rather than the functional product, thus determined whether the CFTC or SEC had jurisdiction to regulate. In order to preserve some aspects of functional regulation, the SEC and CFTC were required to jointly adopt regulations for single stock futures.³⁸⁶ However, that arrangement still left some regulatory differences. For example, an investor trading a single stock future on a stock exchange would have the protection of SIPC insurance. SIPC provides up to \$500,000 in insurance to cover losses caused by a broker-dealer’s insolvency. A customer trading the same single stock future on a DCM

382. 15 U.S.C. § 78c(a)(4)-(5).

383. *Id.* Many banks are still subject to indirect regulation by the SEC when they become public companies. In such cases the bank must register its securities with the SEC and is subject to the SEC’s periodic reporting requirements. *See, e.g.*, Bank of America Corp., Annual Report (Form 10-K) (Feb. 27, 2009) (exemplifying Bank of America’s compliance with SEC reporting requirements).

384. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, §102 (2000).

385. Markham, *supra* note 300 and accompanying text (describing the division of jurisdiction between SEC and CFTC).

386. *See* 7 U.S.C. § 2(1)(D), 17 C.F.R. § 41.41 (implementing the dual regulation of this product).

would have no such protection.³⁸⁷

The use of multiple regulators for the same product expanded with the manipulation of California electricity prices by Enron and other energy companies in 2000 and 2001.³⁸⁸ The CFTC brought a number of manipulation actions as a result of those activities.³⁸⁹ It was joined by the Justice Department in some of those cases. One such case was brought against BP Products of North America Inc. (BP). That company paid \$178 million to settle CFTC charges and an additional \$125 million to settle criminal charges over the same conduct—a total of \$303 million.³⁹⁰ However, the Fifth Circuit threw out a criminal case brought against the BP traders who engaged in the conduct that was the subject of those settlements, finding that the trading was not subject to regulation under the CEA.³⁹¹

The SEC and the Federal Energy Regulatory Commission (FERC) also made an appearance in these prosecutions. The SEC claimed that manipulative trades by the energy companies had inflated the earnings they reported in their SEC filings.³⁹² FERC claimed that these activities violated its competition requirements for pipelines and regulated utilities. Reliant Resources, Inc., (Reliant), for example, was the subject of enforcement proceedings by the SEC, the CFTC, and FERC. Reliant paid \$50 million to settle the FERC charges and \$18 million to settle the CFTC claims. It additionally agreed to pay \$445 million to settle claims brought by the attorney generals of various states. The Justice Department also criminally prosecuted Reliant, but those charges were later dropped.³⁹³

Congress responded to these actions in a non-functional way. Instead of consolidating regulation of energy trading into a single regulator, in

387. The differences in the regulation of single stock futures by the SEC and CFTC are described in a uniform disclosure statement that must be given to customers of those products. See 67 Fed. Reg. 64176 (Oct. 17, 2002) (describing disclosure statement). See also Risk Disclosure Statement for Security Futures Contracts, NFA Compliance Rule 2-30(B), (Rev. Jan. 3, 2011) (describing disclosure and risk information in the National Futures Association manual).

388. See Jerry W. Markham & Lawrence Hunt Jr., *The California Energy Crisis—Enron's Gaming of Governor Gray's Imperfect Market*, 24 FUTURES & DERIVATIVES L. REP. 1 (2004) (describing those manipulations).

389. See Jerry W. Markham, Lawrence Hunt Jr., & Michael S. Sackheim, *Market Manipulation—From Star Chamber to Lone Star Chamber*, 23 FUTURES & DERIVATIVES L. REP. 7 (2003) (describing those cases).

390. CFTC Press Release No. 5405-07, BP Agrees to Pay a Total of \$303 Million in Sanctions to Settle Charges of Manipulation and Attempted Manipulation in the Propane Market (Oct. 25, 2007) (on file with CFTC).

391. *United States v. Radley*, 632 F.3d 177 (5th Cir. 2011).

392. See MARKHAM, *supra* note 289 (describing these actions).

393. *Id.* at 281-282.

2005, Congress granted FERC greater powers to attack energy price manipulations³⁹⁴ through language that tracked the provisions of the SEC's anti-manipulation provisions in Section 10(b) of the Securities Exchange Act of 1934.³⁹⁵ Not satisfied with that expansion of manipulative authority, Congress acted again in 2006 to give the Federal Trade Commission (FTC) the same anti-manipulation powers that it gave FERC for energy price manipulations and which was later granted to the CFTC by the Dodd-Frank Act in 2010.³⁹⁶ This means that four regulators (CFTC, SEC, FERC, FTC), plus the Justice Department have the same powers for regulating energy price manipulations. They will undoubtedly engage in duplicative actions in future energy manipulation cases, as they have in the past.³⁹⁷

These breakdowns to the functional regulation model bloomed into something much greater in the Dodd-Frank Act. That legislation allocated jurisdiction over previously unregulated swap transactions between the SEC and CFTC.³⁹⁸ The CFTC was given jurisdiction over commodity based swaps, while the SEC assumed control over security based swaps.³⁹⁹ This meant that swaps as a financial tool were not regulated functionally. The jurisdictional line between the SEC and CFTC was not drawn on the instrument being traded, *i.e.*, the swap. Rather, jurisdiction was allocated on the basis of the underlying asset that is the subject of the swap, *i.e.*, commodity swaps for the CFTC and security swaps for the SEC. There is nothing functional in such an approach. It was also wasteful in application. While the SEC and CFTC engaged in some joint rulemaking in defining swaps and swap market participants,⁴⁰⁰ they went their separate ways in promulgating business conduct rules for swaps falling within their respective regulatory reach.⁴⁰¹

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

395. 15 U.S.C. § 78j(b).

396. Energy Independence and Security Act, Pub. L. No. 110-140, 121 Stat. 1492 (2007).

397. Indeed, FERC and the CFTC have already engaged in a war over whether they had concurrent jurisdiction over a large energy trader who was alleged to be manipulating natural gas futures. The D.C. Circuit ruled that the CFTC had exclusive jurisdiction over energy futures. *Hunter v. FERC*, 711 F.3d 155 (D.C. Cir. 2013).

398. See Markham, *supra* note 321, at A-51 (describing this legislation).

399. *Id.*

400. This joint rulemaking was done in consultation with the Federal Reserve Board. See, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 Fed. Reg. 30, 596 (May 23, 2012) (comprising the joint final rule).

401. See 17 C.F.R. § 23.400 (describing the CFTC swap business conduct rules). The SEC proposed such business conduct rules in 2011 but has not adopted those rules as of July 10, 2015; SEC, Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42,396 (July 18, 2011) (describing business

This move away from functional regulation was even more pronounced in allocating regulation of the foreign exchange market. As described above, The Futures Trading Act of 1982 and the Reauthorization Act of 2008⁴⁰² acted to open up foreign exchange trading to SEC regulated broker-dealers.⁴⁰³ As also described above, the Dodd-Frank Act went further and allocated jurisdiction over retail foreign exchange derivatives among the SEC, the CFTC, the OCC, the Federal Reserve Board and the FDIC, who were joined by the NFA and FINRA.⁴⁰⁴ The Dodd-Frank Act allocation of this jurisdiction was not functionally based. Rather, it was entity specific regulation, *i.e.*, broker-dealers selling retail foreign exchange options are subject to the regulation of the SEC, FCMs selling the same product are subject to the rules of the CFTC, and banks offering the identical product are subject to the rules of the bank regulators. As the CFTC staff has noted, Dodd-Frank:

permits several types of entities to act as counterparties to retail forex transactions, [but] the question of who regulates the activity depends on the type of entity offering to be the counterparty. For example, SEC-registered brokers or dealers doing retail forex transactions are regulated by the SEC and financial institutions are regulated by banking regulators. The CEA provides that the CFTC has jurisdiction over [futures commission merchants], [retail foreign exchange dealers], or entities that are not otherwise regulated.⁴⁰⁵

B. *A Reassessment of Business Conduct Regulation is Needed*

The functional system of regulation employed in the U.S. was largely the result of legislation that was passed in the 1930s, at a time when financial services were segmented and had little overlap.⁴⁰⁶ These separated financial services were carried out by distinct entities such as

conduct standards).

402. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1982), Food Conservation and Energy Act of 2008, Pub. L. No. 110-246, 122 Stat. 1651 (2008).

403. *Id.*

404. Markham, *supra* note 300 and accompanying text (detailing allocation of jurisdiction).

405. CFTC Office of Public Affairs, Q & A-Final Retail Foreign Exchange Rules (Sept. 10, 2010). Meanwhile, the Treasury Department continues to have exclusive jurisdiction over all players in the commercial interbank foreign currency market. *See* S. Rep. No. 93-1131 (1974) (describing the Treasury Amendment); *Dunn v. CFTC*, 519 U.S. 465 (1997) (describing the Treasury Amendment and CFTC jurisdiction).

406. That legislation included the Securities Exchange Act of 1934 (15 U.S.C. § 1), the Commodity Exchange Act of 1936 (7 U.S.C. § 1) and the Glass-Steagall Act that was passed in 1933 (Banking Act of 1933, Ch. 89, Pub. L. No. 73-66, 48 Stat. 162).

broker-dealers for securities, futures commission merchants for futures and banks for taking deposits and making loans. However, some large banks broke that separation in the 1920s through the use of affiliates that acted as broker-dealers. The activities of those affiliates were harshly criticized in hearings that led to the passage of the New Deal legislation regulating financial services. The Glass-Steagall Act sought to restore the wall between banking and securities by banning banks from engaging in some securities market activities.⁴⁰⁷

The barriers erected by Glass-Steagall that separated the banking and securities markets began breaking down in the 1960s, when large commercial and investment banks began expanding their offerings of financial services.⁴⁰⁸ Similarly, the futures exchanges, which had traditionally traded only agricultural futures, began trading futures and options on financial instruments. Today, futures and other derivative markets are largely devoted to the trading of financial derivatives.⁴⁰⁹ Functional regulation was not a good fit for this evolving market structure. Instead of a single regulator, or group of regulators in the case of banking, large financial services firms and their affiliates were saddled with multiple regulators with separate and sometimes conflicting rules.

This multiplication of regulators burgeoned during the Financial Crisis in 2008. Goldman Sachs, for example, was once regulated only by the SEC, but during that crisis it became a bank that is now regulated by banking regulators, as well as the SEC and CFTC. Morgan Stanley underwent the same metamorphosis. Other large banks also face this same multiple regulator approach. For example, Bank of America was involved in capital market activities before the Financial Crisis and was subject to SEC and CFTC regulation, as well as bank regulation. That cross sector role was expanded by Bank of America during the Financial Crisis when it acquired Merrill Lynch, one of the largest broker-dealers in the world.⁴¹⁰

This duplicative and overlapping regulatory structure has led to the anomaly of multiple enforcement actions by multiple regulators against the same large banks. This multiple regulator role has resulted in the now familiar recurring announcements of mega-settlements by those banks with

407. Markham, *supra* note 383 at 1091-1095 (describing the legislative history of the Glass-Steagall Act).

408. *See id.* at 1081, 1095, 1102 (describing the efforts of banks and broker-dealers to expand into each other's traditional domains).

409. *See* Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 IOWA J. CORP. L. 865, 873-874 (2008) (describing that transformation).

410. *See* JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE SUBPRIME CRISIS TO THE GREAT RECESSION* 546-557 (2011) (describing those developments).

those regulators. These so-called “parallel” actions (*i.e.*, “independent investigations conducted by civil regulatory agencies and federal prosecutors relating to the same set of operative facts and circumstances”)⁴¹¹ were fairly limited before the scandals that emerged after the bankruptcy of the Enron Corp. in 2001. Those scandals spread from the energy markets that Enron was manipulating to several financial services firms.⁴¹² Before the Enron era scandals, the SEC would file its own civil actions and make a simultaneous criminal reference to the Department of Justice in particularly serious cases of fraud, but such dual actions were infrequent. That changed with the failure of Enron in 2001 and the financial services scandals that arose in its wake. In 1999, there were sixty-four such referrals. That number ballooned to 259 in 2002.⁴¹³

The Department of Justice became an active regulator of financial services firms during the Enron era scandals by doling out large fines for violations of regulatory requirements and by coordinating the multiple actions of other regulators. The Enron era scandals resulted in a Corporate Fraud Task Force in 2002 that was headed by the Department of Justice and included representatives from the SEC, CFTC and other regulators. They began joint investigations and parallel criminal and civil proceedings on a broad scale, and that Task Force has continued to expand.⁴¹⁴

The Justice Department website identified the following as members of the Corporate Fraud Task Force in 2008:

Director of the Federal Bureau of Investigation
Assistant Attorney General Criminal Division
Assistant Attorney General Tax Division
United States Attorney for the Central District of California
United States Attorney for the Northern District of California
United States Attorney for the Northern District of Illinois
United States Attorney for the Eastern District of New York
United States Attorney for the Southern District of New York
United States Attorney for the Eastern District of Pennsylvania
United States Attorney for the Southern District of Texas

411. WilmerHale, *The Perils of Parallel Proceedings—Is There Light at the End of the Tunnel?* (April 2006), http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/Editorial/Publication/ICL_BriefSeries_042106.pdf [https://perma.cc/63KR-F79T] (accessed on May 19, 2015).

412. Markham, *supra* note 195 at 496 (describing those scandals).

413. WilmerHale, *Parallel Criminal and SEC Prosecution Present New Risks for Public Companies and their Officers and Directors* (August 19, 2003), <https://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=90061> [https://perma.cc/M62C-G3YS] (accessed on May 19, 2015).

414. *Id.*

The Secretary of Labor
The Department of Housing and Urban Development
The Secretary of the Treasury
The Comptroller of the Currency
The Director of Office of Thrift Supervision
The Special Inspector General for the Troubled Asset Relief Program (TARP)
The Chairman of the Commodities Futures Trading Commission
The Chairman of the Federal Communications Commission
The Chairman of the Federal Energy Regulatory Commission
The Chairman of the Securities and Exchange Commission
The Chairman of the Federal Reserve Board
The Chief Inspector of the United States Postal Inspection Service

The Director of the Federal Housing Finance Agency.⁴¹⁵

In 2009, in the wake of the 2008 Financial Crisis, the Corporate Fraud Task Force was renamed the Financial Fraud Enforcement Task Force (Task Force) and was expanded to include six more federal agencies. The Task Force then included ninety-four U.S. attorneys offices and numerous “state and local partners.”⁴¹⁶ This reference to “state and local partners” recognizes that, in addition to federal regulators, financial services firms are subject to further oversight by state banking commissions, if they are a state bank, fifty-state securities administrators,⁴¹⁷ fifty-state state attorney generals, the same number of state insurance regulators and, in the case of New York, a Department of Financial Services that is charged with, among other things, “fighting financial fraud.”⁴¹⁸

The inclusion of state officials among the host of federal financial services regulators was another product of the Enron-era scandals. Serving

415. Department of Justice Archives, *The President's Corporate Fraud Task Force*, <http://www.justice.gov/archive/dag/cftf/> [<https://perma.cc/MX3X-DMB4>] (accessed on May 18, 2015).

416. *About the Task Force*, STOPFRAUD.GOV: FIN. FRAUD ENFORCEMENT TASK FORCE, <http://www.stopfraud.gov/about.html> [<https://perma.cc/R82P-65JR>] (last visited May 18, 2015).

417. See Kenneth I. Denos, *Blue and Gray Skies: The National Securities Markets Improvement Act of 1996 Makes the Case for Uniformity in State Securities Law*, 1997 UTAH L. REV. 101 (1997) (explaining that the titular legislation preempted state securities laws with respect to actively traded securities regulated by the SEC).

418. *About Us*, N.Y. DEP'T OF FIN. SERV., http://www.dfs.ny.gov/about/dfs_about.htm [<https://perma.cc/DV25-UB7C>] (last visited May 16, 2015).

as attorney general in New York during that period, Eliot Spitzer brought numerous high profile cases against financial institutions, often in competition with the SEC.⁴¹⁹ The press Spitzer garnered from those prosecutions catapulted him into the New York governor's mansion and made him a viable candidate for the Presidency, that is until a scandal led to his downfall.⁴²⁰ Other state officials joined the fray during the Enron-era scandals. For example, a wolf pack of forty state officials joined Spitzer in an investigation of financial analysts employed by several large investment banks. Those state regulators drew lots to determine which regulators would lead investigations of particular investment banks. Utah drew Goldman Sachs as its target, which must have raised some eyebrows in Goldman's New York headquarters.⁴²¹ Those investigations led to a massive settlement by several large investment banks in which they agreed to pay \$1.4 billion to New York and to a long list of state and federal regulators.⁴²²

The financial analyst settlement became the model for the massive fines imposed by multiple regulators in the wake of the Financial Crisis of 2008. For example, a few years after that settlement, another pack of thirty state attorney generals joined the CFTC, bank regulators, and the Department of Justice in investigating the manipulation of the Libor and other benchmark interest rates by several large banks.⁴²³ Regulators from the U.K, Japan, Europe, Canada and Singapore were also involved.⁴²⁴ Those investigations resulted in billions of dollars in settlements.⁴²⁵ In one settlement, Deutsche Bank agreed to pay \$2.5 billion to settle claims over interest rate manipulation that were brought by the CFTC, the Justice Department, the New York Department of Financial Services, and the UK Financial Conduct Authority; Deutsche Bank had previously paid nearly \$1 billion to settle claims by the European Union over interest rate manipulations.⁴²⁶

419. See MARKHAM, *supra* note 196, at 411 (describing Spitzer's prosecutions and his rise and fall as a national figure).

420. *Id.* at xxxi.

421. *Id.* at 411-412.

422. *Id.* at 416.

423. Jean Eaglesham, *Ruling in Rate Probe Doesn't Slow Cases*, WALL ST. J., Apr. 4, 2013, at C1.

424. See MARKHAM, *supra* note 289, at 341 (further describing those investigations).

425. See *supra* notes 198, 200, and 201 (summarizing various settlements reached for billion dollar amounts).

426. Eyk Henning & David Enrich, *Deutsche Bank to Pay \$2.5 Billion to Settle Libor Investigation*, WALL ST. J., Apr. 23, 2015. The CFTC and Department of Justice entered into a \$453 million settlement with Barclays PLC in June 2012. The bank was charged with attempting to manipulate the Libor rate by inserting artificially low quotes in the index during the Financial Crisis. That action was taken to aid trading positions and to conceal

The November 2014 foreign exchange manipulation case settlement for \$4.3 billion, which is described above,⁴²⁷ involved six banks and various domestic and foreign regulators (*i.e.*, the CFTC, the OCC, the U.K. Financial Conduct Authority (FCA) and the Swiss Financial Market Supervisory Authority).⁴²⁸ The large BONY foreign exchange settlement involved the New York and Florida attorney generals, the Justice Department, the Labor Department and the SEC.⁴²⁹ After those settlements, Brazil announced that its antitrust authorities were investigating fifteen large international banks, including several of those involved in the foreign exchange and Libor settlements, to determine if they were manipulating currency exchange rates.⁴³⁰

from the market that Barclays was paying higher rates in order to attract funds. Alexander Alper & Kristin Ridley, *Barclays Paying \$453 million to Settle Libor Probe*, REUTERS, June 27, 2012. On December 19, 2012, A UBS AG subsidiary in Japan pleaded guilty to a criminal charge for manipulating the Libor rate. UBS also agreed to pay civil and criminal fines totaling \$1.5 billion to settle interest rate charges made by U.S., U.K. and Swiss authorities. David Enrich & Jean Eaglesham, *UBS Admits Rigging Rates in 'Epic' Plot*, WALL ST. J., Dec. 20, 2012. The Royal Bank of Scotland agreed to pay \$612 million to settle charges brought by U.S. and U.K. authorities over its Libor rate manipulations. Matt Scuffham & Kristin Ridley, *Exclusive: RBS Fined \$612 Million for Rate Rigging*, REUTERS, Feb. 6, 2013. U.S. and U.K. regulators fined ICAP, an inter-dealer broker, \$87 million for the alleged manipulation of the Libor. Kristin Ridley, Clare Hutchison & Aruna Viswanatha, *ICAP Fined \$87 Million Over Libor, Three Former Staff Charged*, REUTERS, Sept. 25, 2013. In October 2013, the Dutch Rabobank agreed to pay \$1 billion to settle charges that it manipulated the Libor rate. That settlement was with the CFTC, the U.S. Department of Justice, the U.K. Financial Conduct Authority and Dutch regulators. Chad Bray, *Dutch Bank Settles Case Over Libor Deceptions*, N.Y. TIMES, Oct. 29, 2013. In December 2013, European Union regulators fined six large financial institutions \$2.32 billion for manipulating the Libor rate. Those firms included JPMorgan, Citigroup, Deutsche Bank, Royal Bank of Scotland and Société Générale S.A., some of which were later targeted for the same conduct by other regulators. Vanessa Mock & David Enrich, *EU Fines 6 Firms on Rates – Total Penalty of \$2.32 Billion is Bloc's Largest in Case Against Cartel*, WALL ST. J., Dec. 4, 2013. Lloyds Banking Group PLC agreed to pay \$370 million to U.S. and U.K. authorities in July 2014 to settle charges over its alleged repo rate manipulations. Max Colchester, *Lloyds Settles Rate-Rig Probe*, WALL ST. J., Jul. 29, 2014.

427. See FCA, *supra* note 203 (detailing the relevant case against banks whose traders attempted to manipulate market currency rates).

428. See Ring & Vaughan, *supra* note 204 (detailing the regulatory bodies involved in the settlement reports).

429. See *supra* notes 217 and 218 (accounting for the separate actions brought by the Justice Department, the Department of Labor, the SEC, New York attorney general, and the Florida attorney general).

430. Guillermo Parra-Bernal & Leonardo Goy, *Brazil Probes Currency Market Activity of 15 Global Banks*, REUTERS, July 2, 2015. Another storm is brewing over claims that large banks manipulated the market for U.S. Treasury securities. A class action lawsuit filed in July 2015 has charged that twenty-two large banks and financial services firms that act as primary dealers in that market manipulated their prices in 2012. The Treasury market is valued at \$12.5 trillion, so this will be no small matter, and the press was reporting an

As exemplified by the foreign exchange manipulation cases, parallel proceedings have become the norm for prosecuting large financial institutions. However, it is hard to fathom the value of this redundant regulation by multiple regulators of the same banks. It serves no useful purpose other than to milk banks, regardless of guilt or harm, for billions of dollars that they must pay in order to preserve their franchise, which depends on multiple government licenses (*e.g.* FCM, broker-dealer and banking registrations). These settlements merely act as a random tax on those institutions, a tax that is borne by innocent shareholders in the form of reduced earnings, which diminish stock value and dividends. Consumers will also bear some of this burden as they will be charged increased fees to offset the effects of those massive fines.⁴³¹

Reform is necessary, but for the approximately twenty-five financial regulatory reform efforts that occurred after World War II, attempts at reform have all been unsuccessful.⁴³² Reform efforts seemed to have gained some traction in this century when, in 2004, the Government Accountability Office (GAO) published a report on regulatory reform in which it stated that “some have questioned whether a fragmented regulatory system is appropriate in today’s environment, particularly with large, complex firms managing their risks on a consolidated basis.”⁴³³

The GAO report was followed by an extended and extensive review of the effectiveness of functional regulation by the Treasury Department that was concluded in 2007. The Treasury Department then urged that

investigation by the Justice Department of these claims. Jonathan Stempel, *Lawsuit Accuses 22 Banks of Manipulating U.S. Treasury Auctions*, REUTERS, July 23, 2015. This is not the first time that the Treasury market has been manipulated. In 1992, Paul Mozer, a trader at Salomon Brothers, now a part of Citigroup, was the subject of criminal charges for manipulating the two-year Treasury market through massive purchases of those notes at Treasury auctions. The Treasury Department had limited the amount of notes or bonds that any one dealer could purchase at a Treasury auction for two-year notes to 35 percent of the offering. Mozer used customer accounts without their permission to buy 86 percent of the May 1992 two-year Treasury note auction. In one auction, Mozer entered an unauthorized order for \$1 billion for the account of a single customer. Mozer was sent to jail for four months and his firm was fined \$290 million. See MARKHAM, *supra* note 289, at 252-253 (2014) (describing that and other Treasury market manipulation cases).

431. The disposition of these fines is another matter that needs examination. In England, the government was using the Libor settlement for such things as giving the “hippie scouts” some \$750,000 to teach children about peace and cooperation through parachute games and musical chairs. Another \$1.5 million was given to support a celebration of the battle of Agincourt. Money was also given to a “therapeutic baker” for veterans. Margot Patrick, *England’s Bank Fines Are a Boon for a Happy Few – Agincourt Celebration, ‘hippie scouts’ get some of \$1 billion in Libor cash*, WALL ST. J. May 30, 2015.

432. *A Former Central Banker Turns on His Own Kind*, THE ECONOMIST, Apr. 25, 2015.

433. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-61, INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE (2004).

functional regulation be abandoned on the basis that it was ineffective and costly.⁴³⁴ The Treasury Secretary recommended a consolidation of U.S. financial services regulation into three bodies, *viz.*, (1) a market stability regulator, which would be the Federal Reserve Board empowered to set monetary policy and monitor systemic economic threats; (2) a prudential financial regulator, which would oversee government insured banks and broker-dealers and adopt rules for the protection of those industries' government insurance funds (FDIC and SIPC); and (3) a business conduct regulator that would regulate business conduct across all financial services.⁴³⁵ As an interim step the Department's report recommended the consolidation of the CFTC and SEC.⁴³⁶

The Financial Crisis of 2008 killed any possibility of enactment of the Treasury Department's recommended reforms, which may seem strange. The multiple regulators involved in that crisis were anything but functional, finding themselves often at odds with each other during the crisis and doing nothing to prevent or anticipate the crisis.⁴³⁷ Yet, instead of reducing the number of regulators, Congress added even more with the passage of the Dodd-Frank Act in 2010. Among other things, Dodd-Frank created the Consumer Financial Protection Bureau (CFPB), which now enforces federal consumer financial laws such as prohibitions against credit discrimination.⁴³⁸ The CFPB is already following the now familiar path of parallel and redundant enforcement actions.⁴³⁹ Dodd-Frank also created a new super-regulator, the Financial Stability Oversight Council (FSOC), whose members and advisors comprise a broad range of federal and state financial services regulators; FSOC is responsible for regulating systemically important financial services firms.⁴⁴⁰ However, most of those businesses are financial services firms that are already intensively regulated

434. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008).

435. *Id.* at 139-144.

436. *Id.* at 106-111.

437. See MARKHAM, *supra* note 412 (describing those failures).

438. *About Us*, CONSUMER FINANCIAL PROTECTION BUREAU, <http://www.consumerfinance.gov/the-bureau/> [<https://perma.cc/KGP4-JSC8>] (last visited June 28, 2015).

439. For example, in January 2015 CFPB announced a joint investigation with the Maryland attorney general and Maryland Insurance Administration that resulted in joint settlement with Wells Fargo and JPMorgan Chase for \$35.7 million. CONSUMER FIN. PROTECTION BUREAU, CFPB TAKES ACTION AGAINST WELLS FARGO AND JPMORGAN CHASE FOR ILLEGAL MORTGAGE KICKBACKS, (2015).

440. See Jerry W. Markham, *The Financial Stability Oversight Council—Risk Manager or Debating Society?*, 33 THE CAPCO INST. J. FIN. TRANSFORMATION 35 (2011) (describing the role and participants in FSOC).

by multiple other regulators.⁴⁴¹

The functional multiple regulator approach taken by the U.S. has not been followed by the rest of the world. At the turn of the century, the United Kingdom consolidated multiple regulators and self-regulators for financial services into a single body, the Financial Services Authority (FSA).⁴⁴² Indeed, most other countries followed that model. However, the FSA was heavily criticized for its lax regulation before and during the Financial Crisis of 2008. The U.K. then moved to a “Twin Peaks” regulatory approach, which the Netherlands and Australia also use.⁴⁴³

Under the Twin Peaks regulatory approach adopted by the U.K. there is a single bank regulator, the Bank of England, for prudential supervision, and a single regulator, the Financial Conduct Authority (FCA), for business conduct covering all financial services, including banking, securities, currency exchange, derivatives and insurance.⁴⁴⁴ Whether that change will survive the next financial storm is unknown, but the FCA is becoming increasingly aggressive in its regulation as demonstrated by its participation in the Libor and foreign exchange settlements described above.⁴⁴⁵

The regulatory dysfunction that continues in the U.S. is not being completely ignored today. No less a personage than former Federal Reserve Board Chairman Paul Volcker, a true believer in regulation, came out in favor of more consolidated regulation in 2015. Among other things, his proposal would consolidate the CFTC and SEC.⁴⁴⁶ That recommendation should be pursued, and the foreign exchange market provides an ideal laboratory for an experiment to determine if consolidated regulation would be more effective than the present morass.

As has been described above, jurisdiction in foreign exchange markets has been allocated among five regulators *viz.*, the CFTC, SEC, OCC, FDIC, and the Federal Reserve Board. Each and every regulator has promulgated

441. See Financial Stability Oversight Council, U.S. DEP'T OF TREASURY, <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank> [<https://perma.cc/Q6TL-HXME>] (last visited June 30, 2015) (describing the non-bank firms designated as systemically significant).

442. *Who are we?*, FINANCIAL SERVICES AUTHORITY, <http://www.fsa.gov.uk/pages/about/who/index.shtml> [<https://perma.cc/BC3R-TQTZ>] (last visited July 30, 2015).

443. See Markham, *supra* note 298, at 547 (describing these regulatory approaches).

444. See RESEARCH HANDBOOK ON SECURITIES REGULATION IN THE UNITED STATES 504-507 (Jerry W. Markham & Rigers Gjyshi eds., 2014) (describing the change in financial regulation in the U.K.).

445. See *supra* notes 426 and 443 and accompanying text (noting involvement of FCA in the large Libor and foreign exchange settlements).

446. The Volcker proposal quickly came under criticism from the proponents of multiple independent regulators. Emmanuel Olaoye, *Former U.S. CFTC Chair Criticizes Volcker Call to Merge Agency With SEC*, REUTERS, May 20, 2015).

separate regulations for essentially the same product. There is no need for this redundancy. A single business conduct regulator should be responsible for all retail foreign exchange activities, which are largely integrated into the operations of a handful of large banks in the commercial interbank market and a relatively small number of retail dealers. A single regulator should be able to look across and regulate the full range of those financial services.⁴⁴⁷

Of course, any effort to create a single business conduct regulator will encounter stiff resistance from the agencies that regulate foreign exchange. Have no doubt, they will fight desperately for survival and to maintain their turf. The several decades of unsuccessful efforts to combine the CFTC and SEC demonstrate this.⁴⁴⁸ However, this resistance is a political matter that needs to be overcome by demonstrating the true extent of redundancy in the regulation of financial services and how wasteful such redundant regulation is in application. Consolidation of regulation of the foreign exchange market would be a good way to make such a demonstration. This would also be an additional ground for consolidating the SEC and CFTC into a single agency that could then act as a single regulator over all products previously within their jurisdictions as well as foreign exchange. Both of these agencies have experience in regulating foreign exchange, and both have as their mission the sanctioning of fraud and manipulation. In addition, removing the bank regulators from business conduct responsibility for foreign exchange would restore them to their traditional role of prudential regulation governing the safety and soundness of banks and our banking system. That prudential regulation would include continuing supervision over foreign exchange payment and settlement systems that are largely used by banks in the inter-bank foreign exchange market.

CONCLUSION

The regulation of the foreign currency exchange market demonstrates that functional regulation has broken down and jurisdictional boundaries are being set by entity and not by product. It would be a useful experiment to consolidate that regulation of the foreign exchange market into a single business conduct authority with a single set of rules. If successful, other business conduct regulation could be consolidated as well.

447. See *supra* note 446 (documenting the UK “twin peaks” model with a single bank regulator and a single business conduct regulator).

448. See Markham, *supra* note 298 (describing those efforts).