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Regulating Fairness: The Dodd-Frank Act's Fair Dealing Requirement for Swap Dealers and Major Swap Participants

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"Fairness is what justice really is."
—Potter Stewart (1915–1985), Associate Justice, U.S. Supreme Court[1]

I. INTRODUCTION

In the years leading up to the financial crisis of 2008, investment banks and other large financial institutions used tactics that were misleading and unfair in structuring, marketing, selling and otherwise dealing in complex over-the-counter (OTC) derivatives with names such as "swaps,"[2] "collateralized debt obligations,"[3] and "credit

1. Search of Quotes by Potter Stewart, BRAINY QUOTE, http://www.brainyquote.com/quotes/quotes/p/potterstew114112.html (last visited Feb. 17, 2014), *archived at* perma.unl.edu/X5DC-9VU3; *see also Justice Potter Stewart Award*, COUNCIL FOR COURT EXCELLENCE, http://www.courtexcellence.org/justice-potter-stewart-award (last visited Feb. 17. 2014), *archived at* http://perma.unl.edu/SQU6-ZL8D (detailing biographical and professional information on Justice Potter Stewart).
2. *See generally* MICHAEL DURBIN, ALL ABOUT DERIVATIVES 29 (2d ed. 2011) (defining a swap contract as "an agreement to exchange future cash flows"). More specifically, a swap can be described as "an agreement between two parties to exchange payments on regular future dates, where each payment leg is calculated on a different basis." ANDREW M. CHISHOLM, DERIVATIVES DEMYSTIFIED 2

default swaps."[4] A derivative is a financial product whose value is derived from a specific reference asset or underlying variable, such as a commodity or an interest rate.[5] A financial product that is traded OTC is not traded on an organized exchange, but instead negotiated privately between counterparties.[6] For example, some banks that ac-

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(2d ed. 2011). For example, in an interest rate swap, one party will agree to pay a fixed interest rate on a set notional amount (e.g., $100 million) at regular intervals for a specific period of time (e.g., 20 years), while the other party agrees to pay a floating interest rate on the same notional amount. DURBIN, *supra*, at 29–32. These kinds of financial products were collectively referred to as "swaps" in the industry; however, after the financial crisis, federal laws now divide derivatives into categories that include swaps, security-based swaps, mixed swaps, and security-based swap agreements. *See* Commodity Exchange Act, 7 U.S.C. § 1a(42), (47) (2012) (defining the terms "swap," "security-based swap," and "mixed swap"). For the purposes of this Article, it is not necessary to know the specific contours of each sub-category of derivative financial product.

3. Barbara Crutchfield George & Lynn Vivian Dymally, *The End of an Era of Limited Oversight*, 25 FLA. J. INT'L L. 207, 212 n.17 (2013) (defining a collateralized debt obligation (CDO) as "an investment-grade security backed by a pool of bonds, loans, and other assets" (quoting *Collateralized Debt Obligation*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cdo.asp (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/A9AK-3Y5F) (internal quotation marks omitted)); *see also* FIN. CRISIS INQUIRY COMM'N, FINAL REP. ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE U.S. 118 (2011) [hereinafter FCIC FINAL REPORT] (describing CDOs as "structured financial instruments that purchase and pool financial assets, such as the riskier tranches of various mortgage-backed securities" and detailing how CDOs were created).

4. *See* Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. U. CHI. L.J. 1, 22 (2011) (defining credit default swaps (CDSs) as swaps "whose payoffs are derived from the occurrence or non-occurrence of a 'credit event' of some reference entity or entities, such as the bankruptcy of an identified corporation, a debt default by some foreign government, or the third default within a basket of bonds"); Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 170 (2011) ("Credit default swaps are agreements that, in simplest terms, offer insurance-like protection against the risk of a debtor's default on debt obligations."); 156 CONG. REC. S5,821 (daily ed. July 14, 2010) (statement of Sen. Merkley), *archived at* http://perma.unl.edu/4XN-EUF5 ("Then we had credit default swaps. That is a fancy term for insurance on the success of a bond.").

5. Kelly S. Kibbie, *Dancing with the Derivatives Devil: Mutual Funds' Dangerous Liaison with Complex Investment Contracts & the Forgotten Lessons of 1940*, 9 HASTINGS BUS. L.J. 195, 196 n.1 (2013) ("Derivatives are broadly defined as financial instruments whose value is derived from other variables (referred to as 'reference assets' or 'underliers')."); *see also* Timothy E. Lynch, *Gambling by Another Name: The Challenge of Purely Speculative Derivatives*, 17 STAN. J.L. BUS. & FIN. 67, 71 (2011) ("More precisely, a derivative is simply an aleatory contract between two counterparties wherein the payoffs to and/or from each counterparty depend on the outcome of one or a set of extrinsic, future, uncertain event(s) and/or metric(s) and wherein each counterparty expects an outcome opposite to that expected by the other counterparty.").

6. *See* CHISOLM, *supra* note 2, at 1 (defining a financial product that is traded over-the-counter (OTC) as one that is not traded on an organized exchange but instead agreed upon directly with dealers); *see also* Kibbie, *supra* note 5, at 200 ("OTC

ted as OTC derivative dealers[7] pulled toxic assets off their own balance sheets and put them into OTC derivatives without disclosing to counterparties that the derivatives contained underlying assets, such as residential home mortgages, which the banks wanted to get rid of because they expected those assets to perform poorly in the immediate future.[8] In other circumstances, derivative dealers marketed and sold OTC derivatives at inflated prices while simultaneously refusing requests from counterparties to provide information about how those prices had been determined. They would then drastically mark down the estimated value of those same derivatives almost immediately after they were sold.[9] Some swap dealing banks also neglected to disclose materially adverse incentives and other conflicts of interest. This included instances where banks were betting against the OTC derivatives to profit from any decreases in the value of those derivatives,[10] as well as instances where the assets underlying the OTC derivatives had been selected by parties who likely stood to profit if the derivatives performed poorly.[11]

In light of such conduct, congressional leaders wanted to make the country's financial markets fair to participants.[12] In 2010, Congress

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derivatives, the newer category of derivatives, are negotiated agreements that are executed without exchange involvement.").

7. *Dealer*, INVESTOPEDIA, http://www.investopedia.com/terms/d/dealer.asp (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/W7LL-8PG7 (defining a dealer as "[a] person or firm in the business of buying and selling securities for their own account, whether through a broker or otherwise"). More generally speaking, a dealer is "anyone who buys goods or property for the purpose of selling as a business." *Dealer*, THE FREE DICTIONARY, http://legal-dictionary.thefreedictionary.com/dealer (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/8CX6-8L2T.

8. STAFF OF S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 391, 525 (Apr. 13, 2011) [hereinafter STAFF, SENATE REPORT], *archived at* http://perma.unl.edu/H7FC-22EV.

9. *Id.* at 393–94, 557–59.

10. *Id.* at 391, 527; 156 CONG. REC. S5901 (daily ed. July 15, 2010) (statement of Sen. Levin), *archived at* http://perma.unl.edu/4TE5-EHT2 (stating that the "hearings and findings of our Permanent Subcommittee on Investigations . . . dramatically showed how some firms were creating financial products, selling those products to their customers, and betting against those same products" and that "[t]his practice has been likened to selling someone a car with no brakes and then taking out a life insurance policy on the purchaser").

11. STAFF, SENATE REPORT, *supra* note 8, at 396, 564–65.

12. *See* CONG. OVERSIGHT PANEL, 111TH CONG., SPEC. REP. ON REGULATORY REFORM 2 (2009), *archived at* http://perma.unl.edu/8E28-Y3NN. Indeed, the Congressional Oversight Panel that issued a Special report on Regulatory Reform in February 2009 stated that the "present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings." *Id.* Further, the report states,

> [t]he current regulatory system has not only allowed for excessive risk and an insufficient degree of transparency, but it has also failed to pre-

enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[13] that, among other things, directed the U.S. Commodity Futures Trading Commission (CFTC)[14] and the Securities and Exchange Commission (SEC)[15] to promulgate rules requiring certain large financial institutions to act fairly with their counterparties.[16] To that end, Congress directed financial regulators to impose strict ethical business conduct standards on the financial institutions that structured, marketed, and sold OTC derivatives.[17] Specifically,

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> vent the emergence of unfair dealings between actors. Overt lies are dishonest, of course, and lying may trigger legal liability. But fair dealing involves more than refraining from outright lying. Deception and misdirection, [sic] are the antithesis of fair dealing. When the legal system permits deception and misdirection it undermines consensual agreements between parties, the very foundation of a market economy designed to serve all individuals.

Id. at 15; *see also* 156 CONG. REC. S5814 (daily ed. July 14, 2010) (statement of Sen. Murray), *archived at* http://perma.unl.edu/426S-W5SS ("For most Americans, this debate is not complex; it is pretty simple. It is not about derivatives or credit default swaps; it is about fundamental fairness."); 156 CONG. REC. S5905 (daily ed. July 14, 2010) (statement of Sen. Stabenow), *archived at* http://perma.unl.edu/FZG4-VBU3 ("It is time we shine a light on derivatives trading and bring transparency and fairness to this market.").

13. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 U.S.C.), *archived at* http://perma.unl.edu/67LV-9G8S.
14. The CFTC is the equivalent to the Securities and Exchange Commission (SEC), but regulates the markets for futures, options on futures, commodity options, swaps, and certain other derivatives. *See generally* 2 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION § 4.03 (3d ed. 2004).
15. The SEC has not finalized its fair dealing rule. *See* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42,396 (proposed July 18, 2011) (corrected on Aug. 3, 2011). As explained in more detail below, the Dodd-Frank Act gave the SEC regulatory authority over security-based swaps and the CFTC regulatory authority over swaps.
16. *See* Commodity Exchange Act, 7 U.S.C. § 6s(h)(3)(C) (2012) (stating that "[b]usiness conduct requirements adopted by the [CFTC] shall . . . establish a duty for a swap dealer or major swap participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith"); Securities Exchange Act, 15 U.S.C. § 78o-10(h)(3)(C) (2012) (stating that "[b]usiness conduct requirements adopted by the [SEC] shall . . . establish a duty for a security-based swap dealer or major security-based swap participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith[ ]").
17. *Hearing to Examine the Regulation of Over-the-Counter Derivatives*: *Joint Hearing Before the H. Comm. on Agriculture & H. Comm. on Financial Services*, 111th Cong. 10 (July 10, 2009) (statement of Timothy F. Geithner, Secretary, U.S. Dep't of the Treasury), *archived at* http://perma.unl.edu/E59Q-2DZQ ("[W]e propose to require that all OTC derivative dealers and all major market participants be subject to substantial supervision and regulation, including appropriately conservative capital margin requirements, and strong business conduct standards . . . . No dealer in these markets will escape oversight . . . .); *Over-the-Counter Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing before the S. Subcomm. on Securities, Insurance and Investment of the Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 7 (June 22, 2009) (statement

the statutory provisions required regulators to create rules mandating that OTC derivative dealers communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith.[18] The CFTC stated that its fair dealing rule incorporated existing standards of fair play from the National Futures Association (NFA) and the futures industry's self-regulatory organization (SRO), and that the rule would serve to prohibit the kind of improper sales practices mentioned above and documented in an official report by the U.S. Senate's Permanent Subcommittee on Investigations.[19]

The CFTC provided little more than general statements about the kind of communications that the fair dealing rule would prohibit. For example, the specific elements or mental state that would be required for a cause of action under the rule were not clarified. Although the CFTC stated that it "would consider providing further guidance" concerning the fair dealing rule,[20] the agency has yet to do so.

U.S. Supreme Court Associate Justice Potter Stewart once said that "[f]airness is what justice really is"—but what is fairness? One dictionary definition of the word "fair" is "free from bias, dishonesty, or injustice . . . ."[21] By comparison, "unfair" refers to conduct that is "not conforming to standards of justice, honesty, or the like."[22] Unfortunately, those definitions do not provide much help in determining the specific kind of communications that would violate a fair dealing rule for swap dealing banks.

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of CFTC Chair Gary Gensler), *archived at* http://perma.unl.edu/PC2J-SMLU ("We should set business conduct standards to make sure the market is free from fraud, manipulation, and other abuses."); *Financial Derivatives on Energy Markets: Hearing Before the S. Comm. on Energy & Natural Resources*, 111th Cong. 18 (March 9, 2010) (statement of Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n), *archived at* http://perma.unl.edu/4M3A-Q99Z ("There is now broad consensus that dealers should be regulated for all of their derivative business, both customized transactions and standardized ones. [Swap dealers and major swap participants] should be required to meet business conduct standards to a) promote market integrity by protecting the public against fraud, manipulation and other abuses . . . .").

18. *See* 7 U.S.C. § 6s(h)(3)(C); 15 U.S.C. § 78o-10(h)(3)(C).

19. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9770 (Feb. 17, 2012).

20. *Id.*

21. Random House Webster's College Dictionary 478 (1991 Glencoe Ed.); *Fair*, Merriam-Webster, http://www.merriam-webster.com/dictionary/fair (last visited Feb. 20, 2014), *archived at* http://perma.unl.edu/42YB-EEUT (defining the term "fair" as "marked by impartiality and honesty" and/or "free from self-interest, prejudice, or favoritism").

22. Random House Webster's College Dictionary 1454 (1991 Glencoe Ed.); *Unfair*, Merriam-Webster, http://www.merriam-webster.com/dictionary/unfair (last visited Feb. 20, 2014), *archived at* http://perma.unl.edu/VHN2-UAH7 (defining the term "unjust" as "marked by injustice, partiality, or deception" or "not equitable in business dealings").

Legislatively mandating adherence to a vague principle like fairness may be admirable, but it runs the risk of simply adding an ambiguous edict to a regulatory landscape that already includes prohibitions against fraud and misrepresentations. Indeed, a broad-based congressional fair dealing directive is unlike existing prohibitions against fraud or various specific forms of improper conduct that are, by and large, easier to define and recognize than a concept such as "fair dealing." On the other hand, to the extent that a fair dealing rule can be given sufficient specificity and clarity, it could conceivably serve as an effective deterrent to improper conduct that existing statutory and regulatory provisions might be unable capture—a mechanism to reach unfair conduct that merits prohibition but might otherwise fall beyond the reach of existing federal laws and regulations. This Article seeks to better understand this new duty to communicate fairly as it relates to the federal regulation of entities called swap dealers[23] and major swap participants[24] (collectively, "swap en-

23. *See* 7 U.S.C. § 1a(49) (2012) (defining the term swap dealer as "any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps"). There are currently 98 business entities that are provisionally registered as swap dealers. *See Provisionally Registered Swap Dealers*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer (last updated Feb. 10, 2014), *archived at* http://perma.unl.edu/R25Y-GL5L. Included on the list of registered swap dealers are many business entities affiliated with the world's largest global banks, including Bank of America, BNP Paribas, Deutsche Bank, Goldman Sachs, JP Morgan, and Morgan Stanley. *Id.*

24. *See* 7 U.S.C. § 1a(33)(A) (2012) (defining the term "major swap participant" as "any person who is not a swap dealer[,]" but who either "maintains a substantial position in swaps for any of the major swap categories as determined by the [CFTC]" or "whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"). As a general matter, major swap participants include "entities like the hedge fund [Long Term Capital Management] and AIG's financial products subsidiary." 156 CONG. REC. S5922 (daily ed. July 15, 2010) (written statement of Sen. Lincoln). There are only two provisionally registered major swap participants: Cournot Financial Products LLC and MBIA Insurance Corporation. *Provisionally Registered Major Swap Participants*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/LawRegulation/DoddFrankAct/registermajorswappart (last updated Mar. 1, 2013), *archived at* http://perma.unl.edu/5G2E-V6D5. Both of those firms went bankrupt during the financial crisis and were required to register based on their "legacy" portfolio of swaps. Matt Cameron & Joe Rennison, *Zombie Firms Are First Dodd-Frank Major Swap Participants*, RISK MAGAZINE, March 7, 2013, *arvchived at* http://perma.unl.edu/R386-7X4Z ("Credit derivatives product company (CDPC) Cournot Financial Products and monoline insurer MBIA are the first—and so far, only—firms to provisionally register as major swap participants (MSPs) under US Dodd-Frank Act rules, even though both firms are being wound up and have not done any new credit default swap (CDS) business in more than five years.").

tities"),[25] with the goal of determining, to the extent possible, the kinds of communications that the rule prohibits.

Part II of this Article provides background on the relevant portions of the Dodd-Frank Act and describes the CFTC External Business Conduct rulemaking. Part III examines the relevant NFA guidance that the CFTC indicated that it would look to in interpreting the fair dealing rule and finds, among other things, that the relevant NFA precedents prohibit high-pressure sales practices and negligent misrepresentations in promotional material. Part IV describes the improper swap dealer conduct outlined in the Senate Report that—according to the CFTC—would run afoul of the CFTC's fair dealing rule—much of which involves failures to disclose information, such as adverse interests and swap pricing methodology. Part V analyzes whether the implied covenant of good faith and fair dealing in contract law is an appropriate source for additional principles of good faith that could be used in connection with the fair dealing rule. Part V concludes that, while contract law jurisprudence is unsuitable as a source of law for the CFTC's fair dealing rule, an approach similar to the "excluder" conceptualization of good faith used in section 205 of the *Restatement (Second) of Contracts*—in which good faith is not affirmatively defined but given context through concrete examples of bad faith conduct—could serve as a framework for providing additional clarity regarding the kinds of communications that would be considered unfair under the CFTC rule. In short, by applying an excluder conceptualization to the fair dealing rule, the misleading and unfair communications described in NFA guidance and in the Senate Report would provide the specific examples of the kinds of communications that are considered unfair and therefore prohibited. This Article ends with a summarization of observations that result from analysis of NFA guidance, the conduct described in the Senate Report, and the

25. Swap dealers and major swap participants are limited to large financial institutions because one must exceed a significant threshold—measured in terms of billions of dollars in net notional value in swap transactions—to fit within the regulatory definitions for swap dealer and major swap participant. *See, e.g.*, CFTC Regulations, 17 C.F.R. § 1.3(ggg) (2013) (stating that a person is not deemed a swap dealer if "the swap positions connected with those dealing activities into which the person . . . enters over the course of the immediately preceding 12 months . . . have an aggregate gross notional amount of no more than $3 billion, subject to a phase in level of an aggregate gross notional amount of no more than $8 billion."); CFTC Regulations, 17 C.F.R. § 1.3(hhh) (2013) (outlining the two tests for a "substantial position in swaps," with the first test indicating that a person with a daily average current uncollateralized exposure is a major swap participant if such exposure equals or exceeds $1 billion in credit, equity, or other commodity swaps or $3 billion in rate swaps, and the second test dictating that a person with a combined daily average current uncollateralized exposure and potential future exposure is a major swap participant if such combined exposure equals or exceeds $2 billion in credit, equity, or other commodity swaps, or $6 billion in rate swaps).

application of an excluder conceptualization to the CFTC's fair dealing rule.

This Article is the first to undertake in-depth analysis of the Dodd-Frank Act's fair dealing mandate for swap entities, and to propose that an excluder conceptualization as exemplified in Section 205 of the *Restatement (Second) of Contracts* could help provide greater specificity as to the kinds of communications that the fair dealing rule prohibits.

II. THE DODD-FRANK ACT AND EXTERNAL BUSINESS CONDUCT STANDARDS FOR SWAP ENTITIES

A. Congress Reshapes the Regulatory Landscape

Congress passed the Dodd-Frank Act, which President Obama signed on July 21, 2010, to address shortcomings in the existing financial regulatory framework that had become apparent during the financial crisis, including, but not limited to, the lack of regulatory oversight for the OTC derivatives market.[26] Once enacted, the Dodd-Frank Act ushered in some of the most substantial changes to the federal laws governing financial regulation since the Great Depression.[27]

26. 156 CONG. REC. S5820 (daily ed. July 14, 2010) (statement of Sen. Merkley), *archived at* http://perma.unl.edu/9E2H-Y2NP ("I rise to address the Dodd-Frank financial reform bill and to share the reasons it makes a great deal of sense to restore the lane markers and traffic signals to our financial system—lane markers and traffic signals that were ripped away carelessly, thoughtlessly over the course of a decade and led to the economic house of cards that melted down last year, doing enormous damage to America's working families. . . . What really happened? It can be summed up in two words: irresponsible deregulation."); 156 CONG. REC. S5905 (daily ed. July 15, 2010) (statement of Sen. Stabenow), *archived at* http://perma.unl.edu/A35F-84FF ("For too long the over-the-counter derivatives market has been unregulated, transferring risk between firms and creating a web of fragility in a system where entities became to interconnected to fail. It is clear that unregulated derivative markets contributed to the financial crisis that crippled middle-class families."); *Id*. at 5915 (statement of Sen. Reed) ("On derivatives, the bill closes another huge set of regulatory gaps by overturning a law that prevented regulators from overseeing the shadowy over-the-counter derivatives market and, as a result, bringing accountability and transparency to the market."); *Id*. at 5932 (statement of Sen. Cantwell) ("[T]his legislation will be the first time—the first time—the over-the-counter derivatives market in this country will be regulated. . . . So the American people will know something as dangerous as credit default swaps—which brought down our economy—that now for the first time we will have regulation of these over-the-counter derivatives. . . . A $600 trillion market, which is greater than 10 times the size of world GDP, is a danger to our economy if it is not regulated.").

27. *See* James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1811 (2012) ("The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 introduced the most sweeping reforms of financial markets since the Great Depression.").

Title VII of the Dodd-Frank Act[28] amended the Commodity Exchange Act (CEA)[29]—the law that regulates futures, options on futures, commodity options, and certain other derivatives—to establish a comprehensive new regulatory framework for swaps and security-based swaps.[30] Under the Dodd-Frank Act, the CFTC received authority to regulate swaps,[31] and the SEC received regulatory authority over security-based swaps.[32] Generally, swaps are derivative financial products that have underlying assets that, *inter alia*, are commodities, interest rates, government securities, and broad-based security indices. Whereas security-based swaps are based on single securities, loans and reference assets, or narrow-based security indices.[33] While

28. Title VII of the Dodd-Frank Act is named the Wall Street Transparency and Accountability Act of 2010. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 U.S.C.), *archived at* http://perma.unl.edu/67LV-9G8S.
29. Pub. L. No. 74-675, 49 Stat. 1491 (1936) (codified as amended in scattered sections of 7 U.S.C.). The CEA explicitly mentions the importance of fairness to market participants, stating, *inter alia*, that derivatives transactions are "affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, *fair* and financially secure trading facilities" and that the purpose of the CEA is "to promote responsible innovation and *fair* competition among boards of trade, other markets and market participants." 7 U.S.C. § 5(a)–(b) (2012) (emphasis added).
30. Seema G. Sharma, *Over-the-Counter Derivatives: A New Era of Financial Regulation*, 17 LAW & BUS. REV. AMERICAS 279, 281–82 (2011); Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. U. CHI. L.J. 1, 13 n.48 (2011).
31. *See CFTC Glossary*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/index.htm#S (last visited Feb. 16, 2014), *archived at* http://perma.unl.edu/AVQ7-6T7X (definition of "swap"); Lynch, *supra* note 30.
32. *See CFTC Glossary*, *supra* note 31 (definition of "security-based swap"); Sharma, *supra* note 30; *see also Dodd-Frank: Title VII - Wall Street Transparency and Accountability*, LEGAL INFO. INST., http://www.law.cornell.edu/wex/dodd-frank_title_vii (last visited Feb. 16, 2014), *archived at* http://perma.unl.edu/N3HD-YHTQ (explaining basic regulatory framework of the Dodd-Frank Act).
33. CEA § 1a(35), 7 U.S.C. § 1a(35) (2012) defines a "narrow-based security index" as, *inter alia*, one that consists of nine or fewer securities. The term, "broad-based security index," is not defined in the CEA, but CFTC Regulation 41.1(c) defines it as any group or index of securities that is not narrow-based. 17 C.F.R. § 41.1(c) (2013); *see also* Arthur W.S. Duff & David Zaring, *New Paradigms and Familiar Tools in the New Derivatives Regulation*, 81 GEO. WASH. L. REV. 677, 689 (2013) ("Title VII [of the Dodd-Frank Act] splits oversight of the derivatives market between the CFTC and SEC, although the division is rather uneven—the CFTC's purview reaches the broader swath of current and future products. The SEC has been given responsibility over 'security-based swaps,' which include instruments that reference nine or fewer securities. All other swaps are subject to CFTC oversight . . . .); NORA JORDAN ET AL., ADVISING PRIVATE FUNDS: A COMPREHENSIVE GUIDE TO REPRESENTING HEDGE FUNDS, PRIVATE EQUITY FUNDS AND THEIR ADVISERS § 4:12 (2011 ed.) ("The definition of 'swap' under the Commodity Exchange Act is expansive . . . .").

Congress directed both the SEC and CFTC to promulgate fair dealing rules, at the time of this writing, only the CFTC's fair dealing rule has been finalized.[34]

As part of its comprehensive regulatory scheme for swaps transactions under the CEA, the Dodd-Frank Act also created two new types of regulated intermediaries; namely, the aforementioned swap dealers and major swap participants.[35] Pursuant to the Dodd-Frank Act's amendments to the CEA, swap dealers and major swap participants must register with the NFA—the SRO for the U.S. derivatives industry that oversees the registration of intermediaries in the financial markets for derivatives pursuant to a delegation of authority from the CFTC. In addition, Section 731 of Title VII of the Dodd-Frank Act added Section 4s(h) to the CEA, which describes the business conduct standards for swap entities.[36]

The Dodd-Frank Act's business conduct standards for swap dealers include, *inter alia*, a prohibition on fraud and manipulation,[37] a re-

34. Although this Article focuses on regulation of the swaps markets under the CEA, Congress tasked the CFTC and SEC with promulgating rules to implement parallel statutory directives concerning the regulation of swaps and security-based swaps. Section 764 of the Dodd-Frank Act amended the Securities Exchange Act by adding a new Section 15F, codified at 15 U.S.C. § 78o-10. Specifically, new Exchange Act Section 15F(h)(3)(C), 15 U.S.C. § 78o-10(h)(3)(C), states that "[b]usiness conduct requirements adopted by the [SEC] shall . . . establish a duty for a security-based swap dealer or major security-based swap participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith." 15 U.S.C. § 78o-10(h)(3)(C) (2012). Similarly, Section 731 of the Dodd-Frank Act amended the CEA by adding a new Section 4s(h). The new CEA Section 4s(h)(3)(C) uses language that, except for its reference to swap entities and not security-based swap entities, is identical to new Exchange Act 15F(h)(3)(C). *See* CEA § 4s(h)(3)(C), 7 U.S.C. § 6s(h)(3)(C) (2012) (stating that "[b]usiness conduct requirements adopted by the [CFTC] shall . . . establish a duty for a swap dealer or major swap participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith").
35. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80,638, 80,638–39 (proposed Dec. 22, 2010) (stating that Congress enacted the Dodd-Frank Act "to reduce risk" by, *inter alia*, "[p]roviding for the registration and comprehensive regulation of swap dealers and major swap participants"). The Dodd-Frank Act also created two SEC-regulated types of financial intermediaries—"security-based swap dealers" and "major security-based swap participants." Analysis of SEC regulation of security-based swap entities is beyond the scope of this Article.
36. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9805 (Feb. 17, 2012) ("Section 731 of the Dodd-Frank Act, which added new Section 4s(h) to the CEA, gave the [CFTC] broad new authority to set business conduct standards rules for swap dealers and major swap participants in response to abuses in the unregulated derivatives markets. . . . Section 4s(h) is aimed at reversing a caveat emptor trading environment and providing transparency in dealings between swap dealers or major swap participants and their counterparties.").
37. CEA § 4s(h)(1)(A), 7 U.S.C. § 6s(h)(1)(A) (2012).

quirement to disclose to counterparties "information about the material risks and characteristics of [swaps],"[38] and a duty "to communicate in a fair and balanced manner based on principles of fair dealing and good faith."[39] Further, CEA Section 4s(h)(2) describes specific requirements for situations where swap dealers act as counterparties and advisors to "Special Entities"—defined in CEA Section 4s(h)(2)(C) as including taxpayer-funded government entities and municipalities, as well as certain employee benefit plans—with the goal of ensuring that swap dealers do not take advantage of such entities.[40]

B. Regulations Implementing External Business Conduct Standards

On February 17, 2012, the CFTC published in the *Federal Register* final Subpart H of Part 23 of the CFTC's Regulations, which implement the External Business Conduct Standards mandated by CEA Section 4s(h).[41] For example, subsection (a)(3) of CFTC Regulation 23.410 (Prohibition on fraud, manipulation, and other abusive practices) states that it is "unlawful for a swap dealer or major swap participant . . . [t]o engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative."[42] That language mirrors an antifraud provision of the Investment Advisers Act of 1940 that does not require scienter, which is a mental state generally characterized by reckless or intentional behavior,[43] to prove liability.[44] Addi-

38. CEA § 4s(h)(3)(B)(i), 7 U.S.C. § 6s(h)(3)(B)(i) (2012).
39. CEA § 4s(h)(3)(C), 7 U.S.C. § 6s(h)(3)(C) (2012); Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9769 ("The Dodd-Frank Act requires that the [CFTC] establish a duty for swap dealers and major swap participants to communicate in a fair and balanced manner based on principles of fair dealing and good faith.").
40. CEA § 4s(h)(2)(A)–(C), 7 U.S.C. § 6s(h)(2)(A)–(C) (2012).
41. 17 C.F.R. §§ 23.400–23.451 (2013).
42. 17 C.F.R. § 23.410(a)(3) (2013). "[CEA] Section 4s(h)(1) grants the [CFTC] with discretionary authority to promulgate rules applicable to swap dealers and major swap participants related to, among other things, fraud, manipulation and abusive practices." Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9751. Section 4s(h)(1)(A) states that "[e]ach registered swap dealer and major swap participant shall conform with such business conduct standards . . . as may be prescribed by the [CFTC] by rule or regulation that relate to (A) fraud, manipulation, and other abusive practices involving swaps (including swaps that are offered but not entered into)." 7 U.S.C. § 6s(h)(1)(A).
43. Drexel Burnham Lambert Inc. v. Commodity Futures Trading Comm'n, 850 F.2d 742, 748 (D.C. Cir. 1988) (holding reckless conduct sufficient for scienter); U.S. Commodity Futures Trading Comm'n v. Complete Developments, LLC, No. 4:10 CV 2287, 2013 WL 1910436, at *10 (N.D. Ohio May 8, 2013) (describing scienter as a mental state that encompasses reckless and intentional conduct); CFTC's Antidisruptive Practices Authority, 78 Fed. Reg. 31,890, 31,895 & n.66 (May 28,

tionally, CFTC Regulation 23.434 (Recommendations to counterparties—institutional suitability) requires swap dealers to "[u]ndertake reasonable diligence to understand the potential risks and rewards associated with the recommended swap or trading strategy involving a swap; and [h]ave a reasonable basis to believe that the recommended swap or trading strategy involving a swap is suitable for the counterparty."[45]

Likewise, CFTC Regulation 23.431 (Disclosures of material information) requires swap entities to disclose to counterparties "material information concerning the swap in a manner reasonably designed to allow the counterparty to assess" the material risks and characteristics of swaps.[46] The CFTC stated that "[t]he disclosure rules are designed to address historical information asymmetry between counterparties and swap dealers or major swap participants and should enable counterparties to better protect their own interests before assuming the risk of any particular swap transaction."[47] Under the CFTC's disclosure rules, the material risks of a swap that swap entities must disclose include market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks.[48] The material characteristics of a swap that swap entities must disclose

> include the material economic terms of the swap, the terms relating to the operation of the swap, and the rights and obligations of the parties during the term of the swap; and [t]he material incentives and conflicts of interest that the swap dealer or major swap participant may have in connection with a particular swap . . . .[49]

2013) ("Recklessness is a well-established *scienter* standard, which has consistently been defined as conduct that 'departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.'") (quoting *Drexel Burnham Lambert Inc.*, 850 F.2d at 748).

44. The text of CFTC Regulation 23.410(a)(3) is substantially similar to CEA Section 4s(h)(4)(A)(iii). *See* 7 U.S.C. § 6s(h)(4)(A)(iii) (2012). As mentioned previously, courts have held that this language, when used in securities law statutes, imposes liability without scienter. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9752 & n.242 (citing Section 206(4) of the Investment Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21; Securities and Exchange Comm'n v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992)). Regulation 23.410(a)(2), which prohibits fraud against Special Entities, also uses language that has been interpreted as not requiring scienter. *Id.* at 9753 (to be codified at 17 C.F.R. § 23.410(a)–(b)). To ease concerns about these provisions, the CFTC provided an affirmative defense to Regulation 23.410(a)(2) and (3) claims if the swap entity, *inter alia*, "[d]id not act intentionally or recklessly in connection with such alleged violation." 17 C.F.R. § 23.410(b)(1) (2013).
45. *See* 17 C.F.R. § 23.434(a)(1)–(2) (2013).
46. *See* 17 C.F.R. § 23.431 (2013). Regulation 23.431 generally tracks the language of CEA Section 4s(h)(3)(B), 7 U.S.C. § 6s(h)(3)(B) (2012).
47. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9814.
48. 17 C.F.R. § 23.431(a)(1) (2013).
49. 17 C.F.R. § 23.431(a)(2)–(3) (2013).

Material incentives and conflicts of interest include "[a]ny compensation or other incentive from any source other than the counterparty that the swap dealer or major swap participant may receive in connection with the swap."[50]

Further, Regulation 23.431(b) requires swap dealers to inform counterparties that, in connection with any swap not made available for trading on derivatives exchanges or related platforms, they can elect to receive scenario analysis—a process that demonstrates how a particular swap will perform in different market conditions (e.g., higher or lower interest rates, increased asset volatilities, etc.)[51]—"to illustrate the risks of particular derivative products."[52] Additionally, Regulation 23.431(d) requires, *inter alia*, that swap entities provide counterparties to uncleared swaps with a daily mark including "[t]he methodology and assumptions used to prepare the daily mark and any material changes during the term of the swap."[53]

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50. *Id*.
51. *See Scenario Analysis*, INVESTOPEDIA www.investopedia.com/terms/s/scenario_analysis.asp (last visited Feb. 21, 2014), *archived at* http://perma.unl.edu/J8EM-YYKV; *see, e.g.*, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9762 (to be codified at 17 C.F.R. § 23.410(b)).
52. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9762 (to be codified at 17 C.F.R. §23.431(b)).

> Scenario analysis, as required by the proposed rule, would be an expression of potential losses to the fair value of the swap in market conditions ranging from normal to severe in terms of stress. Such analyses would be designed to illustrate certain potential economic outcomes that might occur and the effect of these outcomes on the value of the swap.

Id. at 9761.

53. 17 C.F.R. § 23.431(d)(3)(i) (2013).

> [CEA] Section 4s(h)(3)(B)(iii) directs the [CFTC] to adopt rules that require: (1) For cleared swaps, upon request of the counterparty, receipt of the daily mark of the transaction from the appropriate [derivatives clearing organization]; and (2) for uncleared swaps, receipt of the daily mark of the swap transaction from the swap dealer or major swap participant.

Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9767. "The term 'daily mark' is not defined in the statute, and the [CFTC] understands that the term 'mark' is used colloquially to refer to various types of valuation information." Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg at 80,645. The CFTC defined the term, "daily mark as the 'mid-market mark' . . . [b]ecause 'mid-market' represents an objective value, it provides counterparties with a baseline to assess swap valuations for other purposes, including margin or terminations." *Id.* at 9768 (to be codified at 17 C.F.R. § 23.431(d)).

> The statutory daily mark requirement is meaningless unless the counterparty knows the methodology and assumptions that were used to calculate the mark. To make its own assessment of the value of the swap for its own purposes, the counterparty has to have information from the [swap entity] about how the mid-market mark was calculated.

C. The CFTC's Fair Dealing Rule

Included among the CFTC's External Business Conduct Standards is Regulation 23.433[54]—referred to as "the fair dealing rule"[55]—which, in language that is largely identical to the statute, CEA Section 4s(h)(3)(C),[56] states that "[w]ith respect to any communication between a swap dealer or major swap participant and any counterparty, the swap dealer or major swap participant shall communicate in a fair and balanced manner based on principles of fair dealing and good faith."[57] CFTC Regulation 23.433 has the potential to be an important component of the Dodd-Frank Act's regulatory mosaic by prohibiting improper conduct that other business conduct standards might not reach.

> [T]he fair dealing rule protects market participants and the public by requiring that communications between swap dealers or major swap participants and their counterparties are conducted based on principles of fair dealing and good faith. The rule raises the standard for communications in the previously unregulated swaps market and encourages confidence in the swap market by market participants and the public.[58]

The CFTC stated:

> In determining whether a communication with a counterparty is fair and balanced, the [CFTC] stated that it expects a swap dealer or major swap participant to consider factors such as whether the communication: (1) Provides a sound basis for evaluating the facts with respect to any swap; (2) avoids making exaggerated or unwarranted claims, opinions or forecasts; and (3) balances any statement that refers to the potential opportunities or advantages presented by a swap with statements of corresponding risks.[59]

The first factor is ambiguous and would benefit from interpretive guidance on the part of the CFTC, although it does show that one purpose of the fair dealing rule is to ensure that communications provide

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Id.

54. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9769–70 (to be codified at 17 C.F.R. § 23.433).
55. *See, e.g.*, *id*. at 9769 (to be codified at 17 C.F.R. § 23.433) (referring to Regulation 23.433 as "the fair dealing rule"). The CFTC also referred to Regulation 23.433 as "the communications-fair dealing rule," *id.* at 9811, and "[t]he fair dealing communications rule." *Id.* at 9769 n.496 (to be codified at 17 C.F.R. § 23.433). The CFTC adopted the fair dealing rule as it was originally proposed. *Id.* at 9769.
56. *Compare* 17 C.F.R. § 23.433 (2013), *with* CEA § 4s(h)(3)(C), 7 U.S.C. § 6s(h)(3)(C) (2012).
57. 17 C.F.R. § 23.433; *see* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9741 ("The final fair dealing rule will apply to all communications by a swap dealer or major swap participant in connection with a swap, including communications made prior to an offer.").
58. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9813.
59. *Id.* at 9769.

counterparties with sufficient information to evaluate swaps. Consequently, deliberately communicating in a manner that obscured facts about swaps or made it difficult to evaluate swaps likely would violate Regulation 23.433. The last two factors listed are not entirely surprising, given that federal courts and the CFTC generally have considered exaggerated and unwarranted claims, as well as unbalanced statements that overly emphasize potential profits or unduly minimize risks, to constitute fraud under pre-Dodd-Frank Act antifraud provisions of the CEA.[60] Furthermore, fraudulent communications also should violate any conceivable set of principles of good faith and fair dealing (under Regulation 23.433 or otherwise).[61] The adopting release did not address the extent to which the fair dealing rule might prohibit exaggerated or unbalanced statements that do not rise to the level of fraud, although it seems likely that Regulation 23.433 would do so. After all, before the Dodd-Frank Act, the CEA already contained several antifraud provisions, and it seems unlikely that Congress would have directed the CFTC to craft a fair dealing duty for swap entities merely to duplicate existing antifraud measures.

Regulation 23.433 broadly applies to any communications concerning a swap[62]—including communications with prospective

60. Decisional law under the CEA indicates that material omissions—such as not mentioning one's losing investment track record—can be fraudulent, as can unbalanced communications that exaggerate the likelihood of experiencing profits while downplaying the risk of losses. *See, e.g.*, Commodity Futures Trading Comm'n v. R.J. Fitzgerald & Co., Inc., 310 F.3d 1321, 1329 (11th Cir. 2002) ("Read for its *overall message*, and how that message would be interpreted by an objectively reasonable television viewer, the Commercial overemphasizes profit potential and downplays risk of loss, presenting an unbalanced image of the two. . . . Against these highly alluring statements is only boilerplate risk disclosure language. We agree with CFTC's position that these statements directly contravene the legal principles established in prior commodities fraud cases."); Commodity Futures Trading Comm'n v. Commonwealth Fin. Group, Inc., 874 F. Supp. 1345, 1353 n.10 (S.D. Fla. 1994) ("Plaintiffs suggest that it amounts to a misrepresentation when salespeople emphasize the profits enjoyed by Commonwealth customers without mentioning any of the losses. The Court agrees."); Commodity Futures Trading Comm'n v. Risk Capital Trading Group, Inc., 452 F.Supp.2d 1229, 1245–46 (N.D. Ga. 2006) (finding failure to disclose investing track record in which the overwhelming majority of customers had lost their investments was a material factual omission); *In re* JCC, Inc., [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) 26,080 (CFTC May 12, 1994), *aff'd*, JCC, Inc. v. Commodity Futures Trading Comm'n, 63 F.3d 1557 (11th Cir. 1995) ("When the language of a solicitation obscures the important distinction between the possibility of substantial profit and the probability that it will be earned, it is likely to be materially misleading to customers.").

61. In other words, it stands to reason that all fraudulent communication also would be classified as "unfair," although some "unfair" communications might not be fraudulent.

62. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9741.

counterparties[63]—by swap dealers and major swap participants,[64] unlike some business conduct standards, which only apply to swap dealers.[65] The CFTC stated that, "[u]nder all circumstances . . . the [CFTC's] fair dealing rule . . . operate[s] as an independent basis for enforcement proceedings"[66] and "ensures that swap dealers' and major swap participants' communications to counterparties [will not be] exaggerated and [that] discussions or presentations of profits or other benefits [will be] balanced with the associated risks."[67] The CFTC also indicated that the fair dealing rule imposes "ongoing duties" on swap entities that "continue after the execution of the swap," such that the rule applies, for example, to material amendments to the terms of swaps.[68]

D. Relationship with Other External Business Conduct Standards

Congress, in adding Section 4s to the CEA, directed the CFTC to adopt several different specific kinds of regulations governing the business conduct standards for swap entities, including the fair dealing rule (CEA Section 4s(h)(3)(C)),[69] abusive practices rules (CEA Sections 4s(h)(1)(A) and 4s(h)(4)(A)),[70] and disclosure rules (CEA Section 4s(h)(3)(B)).[71] Therefore, Congress expressly contemplated that the behavior of swap entities would be governed by an interwoven network of rules. In keeping with congressional intent, the CFTC's adopting release for the final rules frequently referred to Regulation 23.433 as working in conjunction with other External Business Conduct Standards.[72] The CFTC stated that "requiring both the disclo-

63. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80,638, 80,641 (proposed Dec. 22, 2010) ("For example, the fair and balanced communications and fair dealing requirements in proposed [Regulation] 23.433 apply to [swap entities] with respect to both counterparties and prospective counterparties.").
64. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9743; *see id.* at 9770.
65. *See, e.g.*, 17 C.F.R. §§ 23.434, 23.440 (2013).
66. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9769 (to be codified at 17 C.F.R. § 23.433).
67. *Id.* at 9811. "A frequent criticism of the swaps market leading up to the 2008 financial crisis was that dealers engaged in self-dealing to the detriment of customers and counterparties, such as by offering swaps and trading strategies that the dealers knew were unsuitable for the specific counterparty." *Id.* at 9809.
68. *Id.* at 9741.
69. 7 U.S.C. § 6s(h)(3)(C) (2012) directed the CFTC to promulgate a fair dealing rule.
70. CEA § 4s(h)(1)(A), 7 U.S.C. § 6s(h)(1)(A) gave the CFTC authority to promulgate an antifraud rule for swap entities. The CFTC did so using language that tracked CEA § 4s(h)(4)(A), 7 U.S.C. § 6s(h)(4)(A).
71. The CFTC's disclosure rules for swap dealers derive from 7 U.S.C. § 6s(h)(3)(B).
72. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9769 (Feb. 17, 2012) (to be codified at 17

sure of material information and fair dealing will enhance transparency and promote counterparty confidence in the previously unregulated swap market, which better enables counterparties to use swaps to assume and manage risk."[73]

For example, the fair dealing rule can be viewed as supplementing Regulation 23.431(b), which allows counterparties to elect to receive a scenario analysis from swap dealers in certain circumstances. Specifically,

> [t]o ensure fair and balanced communications and to avoid misleading counterparties, swap dealers and major swap participants also [are] required to state the limitations of the scenario analysis, including cautions about the predictive value of the scenario analysis, and any limitations on the analysis based on the assumptions used to prepare it.[74]

The CFTC stated that providing counterparties with "appropriate warnings about the assumptions and limitations underlying the scenario analysis" is "consistent with [Regulation] 23.433."[75] In a similar vein, a swap entity cannot simply provide a counterparty to an uncleared swap with a daily mark without also providing background information about how the mark was calculated because the fair dealing rule, in conjunction with Regulation 23.431(d), "requires disclosure of the methodology and assumptions underlying the daily mark."[76]

Furthermore, the CFTC stated that a single communication could violate multiple External Business Conduct Standards. For example, the adopting release stated that Regulation 23.431(a)(3) requires disclosure of "fee rebates, discounts, and revenue and profit sharing" that swap entities receive "for use of various market infrastructures" (e.g., derivatives exchanges or clearinghouses) because those arrangements "constitute material incentives or conflicts of interest."[77] The adopting release further stated that "[s]uch disclosure also is encompassed

C.F.R. § 23.433) (stating that "the fair dealing rule works in tandem with both the material disclosure and anti-fraud rules to ensure that counterparties receive material information that is balanced and fair at all times"); *see id.* at 9811, 9813. "In addition to [CFTC Regulation 23.410], [swap entities] are subject to all other applicable provisions of the CEA and [CFTC] Regulations, including those dealing with fraud and manipulation (e.g., Sections 4b, 6(c)(1) and (3), and 9(a)(2) of the CEA (7 U.S.C. 6b, 9(c)(1) and (3), and 13(a)(2)), and [Regulations] 180.1 and 180.2 (17 C.F.R. 180.1 and 180.2))." *Id.* at 9752 n.239.

73. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9814.
74. *Id.* at 9761.
75. *Id.* at 9763 (to be codified at 17 C.F.R. § 23.431(b)).
76. *Id.* at 9768 (to be codified at 17 C.F.R. § 23.431(d)). "The fair dealing communications rule applies to all communications between a counterparty and a swap dealer or major swap participant, including the daily mark and termination." *Id.* at 9769 n.496 (to be codified at 17 C.F.R. § 23.433).
77. *Id.* at 9766 (to be codified at 17 C.F.R. § 23.431(a)(3)).

in the duty to communicate in a fair and balanced manner."[78] Additionally, "the failure to disclose this information [i.e., about incentives such as fee rebates, discounts and the like to swap entities from market infrastructures] or other material disclosures under the rule may be a material omission under the [CFTC's] anti-fraud provisions, including [Regulation] 23.410(a)."[79] Therefore, one communication—or omission—by a swap entity could violate the fair dealing rule, disclosure rules, and abusive practices rules.

In explaining what the fair dealing rule requires, the CFTC stated:

> The fair dealing rule, like the disclosure rules, is principles based and applies flexibly based on the facts and circumstances of a particular swap. For example, when addressing the risks and characteristics of a swap with features including, but not limited to, caps, collars, floors, knock-ins, knock-outs and range accrual features that increase its complexity, the fair dealing rule requires the swap dealer or major swap participant to provide a sound basis for the counterparty to assess how those features would impact the value of the swap under various market conditions during the life of the swap. In a complex swap, where the risks and characteristics associated with an underlying asset are not readily discoverable by the counterparty upon the exercise of reasonable diligence, the swap dealer or major swap participant is expected, under both the disclosure rule and fair dealing rule, to provide a sound basis for the counterparty to assess the swap by providing information about the risks and characteristics of the underlying asset. The fair dealing rule also will supplement requirements to inform counterparties of material incentives and conflicts of interest that would tend to be adverse to the interests of a counterparty in connection with a swap, particularly in situations like those referenced in the Senate Report. In this regard, a swap dealer or major swap participant will have to follow policies and procedures reasonably designed to ensure that the content and context of its disclosures are fair and complete to allow the counterparty to protect itself and make an informed decision.[80]

The fair dealing rule also applies to communications subject to the institutional suitability rule and CFTC Regulations governing requirements for communications with Special Entities. For example, the CFTC stated that "[d]epending on the facts and circumstances, a violation of the suitability duty may also violate other rules, including the anti-fraud and fair dealings rules."[81] The CFTC also noted that all communications by swap dealers with Special Entities "must be made in a fair and balanced manner based on principles of fair dealing and good faith in compliance with [Regulation] 23.433."[82]

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78. *Id.*

79. *Id.*

80. *Id.* at 9769–70 (to be codified at 17 C.F.R. § 23.433).

81. *Id.* at 9772 n.538 (to be codified at 17 C.F.R § 23.434). Also, two of the abusive practices rules—Regulation 23.410(a)(1) and (2)—prohibit fraud by swap entities in their interactions with Special Entities. 17 C.F.R. § 23.410(a)(1)–(2) (2013).

82. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9784 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.440).

Additionally, the CFTC stated that the fair dealing and disclosure rules serve common regulatory objectives.

> The disclosure and fair dealing regime imposed by Section 4s(h) reverses the caveat emptor environment that permeated the unregulated derivatives marketplace prior to enactment of the Dodd-Frank Act and afforded little transparency or protection for either sophisticated counterparties or Special Entities. Legislative history indicates that the business conduct standards in Section 4s(h) were the result of widespread concerns about sharp practices and significant information asymmetries between swap dealers and their counterparties that created significant imbalances in their respective bargaining power and the assumption of unanticipated risks by counterparties. The disclosure and fair dealing rules implement the statutory objective of transparency for all swap transactions.[83]

The CFTC stated further that, in implementing the External Business Conduct Standards, it sought "to limit the ability of dealers to employ abusive practices that could disadvantage market participants that are less sophisticated or have less market power."[84] Regulation 23.433 is a key component of the CFTC's efforts to meet that objective because "[t]he fair dealing rule requires swap dealer and major swap participant communications to be fair and balanced and restricts misleading or other potentially abusive communications that could undermine the price discovery function of the swap market."[85]

While the fair dealing, abusive practices, and disclosure rules are designed to work together to prohibit improper acts on the part of swap entities, the extent to which one of the rules would prohibit conduct that the others would permit (and vice versa) is unclear. Congress directed the CFTC to craft three different business conduct standards—fair dealing, abusive practices, and disclosure—and Congress likely would not have done so if it had believed that those three standards would be entirely redundant. Therefore, the fair dealing rule likely reaches at least some communications that the abusive practices and disclosure rules do not cover.[86] To better discern the fair dealing rule's scope, derivatives industry guidance might be helpful.

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83. *Id.* at 9811.
84. *Id.* at 9805–9806; *see* Duff & Zaring, *supra* note 33, at 692 ("Swap dealers must treat their counterparties with respect—that is, they may be held to representations on which those counterparties could reasonably rely, a basic tenet of contract law's estoppel function, but one of previously more suspect applicability in the rough and tumble world of derivatives traders—and must communicate with them in a fair and balanced manner.").
85. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9813.
86. Likewise, the disclosure rules probably mandate some disclosures that, if omitted, would not rise to the level of making a communication unfair in violation of Regulation 23.433 or fraudulent in violation of Regulation 23.410.

III. LOOKING TO NFA GUIDANCE WHEN INTERPRETING THE FAIR DEALING RULE

A. Industry Familiarity with SRO "Precedents"

The CFTC sought to alleviate concerns about the ambiguous nature of Regulation 23.433 by stating that the CFTC "will look to" and "consider NFA guidance when interpreting [CFTC Regulation] 23.433,"[87] such as NFA's "customer communications rule."[88] The SEC took an identical approach in its own proposed fair dealing rule, citing to the customer communications rule of the securities industry SRO, the Financial Industry Regulatory Authority (FINRA).[89] Indeed, the CFTC stated that its approach in adopting Regulation 23.433 was "harmonized with the SEC's proposed Fair and Balanced Communications rule for [security-based swap] Entities."[90] The CFTC also stated that its fair dealing rule and other External Business Conduct Standards are based on principles that "are well established in the futures and securities markets, particularly through [the rules of industry self-regulatory organizations (SROs),]"[91] and that, accordingly, adopting the fair dealing rule to cover the behavior of swap entities "harmonizes" the fair dealing obligations in the swaps markets with those in the futures and securities markets.[92] Notably, the CFTC stated that "SRO rules, in particular, provide a useful model because historically

87. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9770 (to be codified at 17 C.F.R. § 23.433) (stating that the CFTC would "look to NFA guidance when interpreting" the fair dealing rule); *id.* at 9812 (stating that the CFTC would "consider NFA guidance when interpreting" the fair dealing rule).

88. *Id.* at 9769.

89. Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42,396, 42,418–19 (July 18, 2011).

90. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9811 n.968.

91. *Id.* at 9769; *see id.* at 9735 n.9 ("The proposed and final rules are informed by existing requirements for market intermediaries under the CEA and [CFTC] Regulations, the federal securities laws, self-regulatory organization ('SRO') rules, prudential regulator standards for banks, industry 'best practices' and requirements applicable under foreign regulatory regimes."); *id.* at 9742 (to be codified at 17 C.F.R. § 23.400) ("Many of the discretionary rules adopted by the [CFTC] are based generally on existing [CFTC] and SRO rules for registrants and industry best practices, and extending them to swap dealers and, where appropriate, to major swap participants will promote regulatory consistency.").

92. *Id.* at 9811 ("The fair dealing rule also benefits swap dealers and major swap participants by harmonizing the statutory requirements with similar protections that currently apply to registrants in the futures and securities markets."); *id.* at 9812 ("The Commission believes harmonizing with existing SRO rules and precedents in the futures and securities markets diminishes the potential costs associated with legal uncertainty.").

the [CFTC] has relied on SROs to regulate conduct that is unethical or otherwise undesirable, but may not be fraudulent."[93]

Because the CFTC stated that it would "look to" and "consider" "NFA guidance" when interpreting the fair dealing rule,[94] a closer examination of relevant NFA rules and interpretive notices is necessary to better understand Regulation 23.433. Under the CEA (as amended by the Dodd-Frank Act) and CFTC Regulations, futures exchanges (contract markets), swap execution facilities, and registered futures associations serve as SROs, in which capacity they are subject to oversight by the CFTC.[95] The NFA, which started operations in 1982, is the only registered futures association.[96] As mentioned previously, the Dodd-Frank Act amended the CEA to enable the CFTC—which previously had regulated, *inter alia*, the markets for futures, options on futures, and commodity options—to also regulate the markets for swaps and other OTC derivatives. Accordingly, the NFA's jurisdiction expanded to include swap entities, as the CFTC delegated to the NFA, *inter alia*, administration of the registration process for swap entities.[97] Section 17(p)(3) of the CEA mandates that each registered futures association adopt rules to "establish minimum standards governing the sales practices of its members and persons associated

93. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80,638, 80,639 n.11 (proposed Dec. 22, 2010) (citing NFA Compliance Rule 2-4, Just and Equitable Principles of Trade); *see* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9806 ("Where possible, the rules are harmonized with requirements in related market sectors, industry best practice recommendations and SRO rules."). This statement also is further evidence that the CFTC intends for the fair dealing rule to prohibit "undesirable" behavior that does not rise to the level of fraud.

94. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9770 (to be codified at 17 C.F.R. § 23.433) (stating that the CFTC "is confirming that it will look to NFA guidance when interpreting [Regulation] 23.433").

95. 17 C.F.R. § 1.3(ee) (2013).

96. *See NFA Manual*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/7G3M-FE8S; Gary Rubin, *CFTC Regulation 1.59 Fails to Adequately Regulate Insider Trading*, 53 N.Y.L. SCH. L. REV. 599, 606 (2008–09) ("The 1974 [Commodity Futures Trading Commission Act] also authorized the creation of 'registered futures associations.' This legislation led to the establishment of the [NFA], a nationwide SRO, for the futures industry, in 1982.").

97. Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613, 2619 (Jan. 19, 2012) (stating "the [CFTC] intends to delegate its full registration authority under the CEA and its regulations to NFA with respect to applicants for registration, and registrants, as [a swap dealer or major swap participant]"); Performance of Registration Functions by National Futures Association with Respect to Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2708, 2709 (Jan. 19, 2012) (CFTC Order "authorizing NFA . . . to perform the full range of registration functions under the CEA and the [CFTC's] regulations with regard to [Swap Dealer]s and [Major Swap Participant]s").

therewith."[98] In keeping with that mandate, the NFA establishes and enforces standards of professional conduct among market participants.[99] Under CFTC oversight, the NFA passes rules and performs audits and examinations of market intermediaries to ensure compliance with those rules.[100]

The NFA also takes disciplinary actions against Members and Associates[101] that violate its rules and provides a forum for arbitration and mediation of disputes.[102] The NFA has the authority to discipline any Member or Associate that is required to register with the CFTC.[103] The NFA's Compliance Department monitors Members and Associates for compliance with NFA's financial and business conduct rules.[104] If Compliance Department staff members believe that a Member or Associate has violated an NFA Rule, they prepare a written report about the matter, which is submitted to the NFA's Business Conduct Committee.[105] The Business Conduct Committee then determines whether to serve a written complaint outlining the alleged vio-

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98. CEA § 17(p)(3), 7 U.S.C. § 21(p)(3) (2012).

99. *See About NFA*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/NFA-about-nfa/index.HTML (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/FLF8-JGRV ("National Futures Association (NFA) is the self-regulatory organization for the U.S. derivatives industry, including on-exchange traded futures, retail off-exchange foreign currency (forex) and OTC derivatives (swaps).").

100. *See* Kurtis J. Ward, *The Futures Industry: From Commodities to the Over-The-Counter Derivatives Markets—Origin, Purpose, Development, Controversy, and Regulation of the Most Volatile Financial Contracts in the World*, 12 PIABA B.J. 8, 13 (2005) ("The NFA performs several regulatory activities such as (1) auditing members to enforce compliance with NFA financial requirements; (2) establishing and enforcing rules and standards for customer protection; (3) conducting arbitration of futures-related disputes; and (4) performing screening to determine fitness to become or remain an NFA member.").

101. NFA defines the term, "Member," to mean member of the NFA, and the term, "Associate," to mean an "associated person" (AP) as defined by the CEA and CFTC Regulations. *See* Article of Incorporation XVIII(c), (q), NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=ARTICLE%20XVIII&Section=2 (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/SFL2-KVNR (defining "associate" and "member"). Generally speaking, an AP is a natural person who is a salesperson for a registered intermediary or who supervises salespeople. *See* 17 C.F.R. § 1.3(aa)(3) (2013) (defining, for example, an AP of a CPO as "any natural person who is associated . . . with . . . [a] commodity pool operator as a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged").

102. *See NFA Manual*, *supra* note 96 (describing, *inter alia*, "Disciplinary Proceedings").

103. *Id.*

104. *Id.*

105. *Id*.

lations.[106] Penalties can include, among other things, a censure, a reprimand, a fine not to exceed $250,000 per violation, expulsion, or suspension from NFA membership for a specified period.[107] Decisions in NFA disciplinary cases are posted on the NFA's website.[108] The decisions provide guidance concerning the specific kind of conduct prohibited by NFA rules.[109]

In adopting the External Business Conduct Standards, the CFTC stated that Regulation 24.431(a)(1) would impose "duties [on swap entities that] are consistent with longstanding legal, regulatory and industry best practice standards, which are familiar to the financial services industry and the OTC derivatives industry."[110] Indeed, the CFTC stated that "[t]he duty to communicate in a fair and balanced manner is one of the primary requirements of the NFA customer communications rule and is designed to ensure a balanced treatment of potential benefits and risks [of a swap transaction]."[111] The CFTC also supported its argument that the principles behind the fair dealing rule were "well established in the futures and securities markets"[112] by citing the following sources (among others):

(1) CFTC Regulation 170.5, which (as quoted in the External Business Conduct Standards adopting release) states that "[a] futures association must establish and maintain a program

106. *Id.*

107. *Id*.

108. *Enforcement and Registration Actions*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/news/newsActionsList.asp (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/XNK6-HBQ2.

109. *Interpretative Notice 9003*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9003&Section=9 (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/5VJA-SCNK ("[NFA Compliance Rules] are general in nature and may not always provide specific guidance as to what particular conduct may be prohibited. It is expected that more detailed content will be given to those general rules through the work of NFA's Business Conduct Committees, which will issue decisions in disciplinary cases applying the rules to specific conduct.").

110. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9761 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.431(a)(1)); *see* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80,638, 80,639 (proposed Dec. 22, 2010).

111. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9769.

112. *See id.* at 9769; *id*. at 9811 ("The fair dealing rule also benefits swap dealers and major swap participants by harmonizing the statutory requirements with similar protections that currently apply to registrants in the futures and securities markets."); *see also* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. at 80,646 (citing NFA Compliance Rule 2-29(b)(2), (5) and NFA Interpretive Notice 9043).

for . . . the adoption of rules . . . to promote fair dealing with the public."[113]

(2) NFA Compliance Rule 2-29—Communications with the Public and Promotional Material—which, *inter alia*, prohibits fraud and high-pressure sales practices;[114]

(3) NFA Interpretive Notice 9041—Obligations to Customers and Other Market Participants—which states that, "[s]ince NFA is a registered futures association, the [CEA] requires it to have rules designed to promote fair dealing with customers and other market participants"[115] and notes that NFA Compliance Rule 2-4[116] "includes a requirement to deal fairly with customers and other market participants at all times;"[117]

(4) NFA Interpretive Notice 9043—NFA Compliance Rule 2-29: Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products[118]—which, as the External Business Conduct Rules adopting release notes, states that "performance must be presented in a balanced manner."[119]

The adopting release further stated that "[t]he [CFTC] concludes that the futures and securities industry familiarity with these precedents [i.e., NFA guidance] considerably mitigates concerns about legal

113. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. at 9769 n.484.

114. *Rule 2-29. Communications with the Public and Promotional Material*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=RULE%202-29&Section=4 (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/CA3W-UP3Q.

115. *Interpretive Notice 9041*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9041&Section=9 (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/B2AH-XTCY.

116. *Rule 2-4. Just and Equitable Principles of Trade*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=RULE%202-4&Section=4 (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/C3ZX-P3QT (stating that NFA "[m]embers and Associates shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business").

117. *Interpretative Notice 9041*, *supra* note 115 ("Under NFA Compliance Rule 2-4 and 2-29(a)(1), all communications with the public regarding securities futures products must be based on principles of fair dealing and good faith and no material fact or qualification may be omitted if the omission, in light of the context of the material presented, would cause the communication to be misleading.").

118. *Interpretative Notice 9043*, NAT'L FUTURES ASS'N, https://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9043&Section=9 (lasted visited Feb. 23, 2014), *archived at* http://perma.unl.edu/F6C6-3URG (stating that "NFA Compliance Rule 2-29 imposes high standards on Members' and Associates' communications with the public.").

119. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9769 n.485 (Feb. 17, 2012).

certainty as a result of the principles based rule."[120] Accordingly, a deeper examination of the "precedents" cited by the CFTC should provide greater clarity regarding the kinds of communications that the fair dealing rule prohibits.

1. *NFA Compliance Rules 2-2 and 2-4*

NFA Compliance Rule 2-2 prohibits Members and Associates from engaging in a laundry list of improper acts against "commodity futures customers."[121] The list of prohibitions includes, but is not limited to, cheating, defrauding or deceiving customers, engaging in manipulative acts or practices, and embezzling money.[122] NFA Compliance Rule 2-4 (Just and Equitable Principles of Trade) states, "Members and Associates shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business."[123] The NFA has interpreted Compliance Rule 2-4 to require "each [futures commission merchant] Member, or in the case of introduced accounts, the Member introducing the account[, to] make available to its customers, prior to the commencement of trading, information concerning the costs associated with futures transactions."[124]

2. *NFA's Customer Communications Rule*

The External Business Conduct Standards adopting release implies that the NFA customer communications rule—Compliance Rule 2-29—and associated Interpretive Notices are among the most important precedents to consider when interpreting Regulation 23.433.[125]

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120. *Id.* at 9770 (to be codified at 17 C.F.R. § 23.433).

121. *Rule 2-2. Fraud and Related Matters*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=RULE%202-2&Section=4 (last visited Feb. 17, 2014) *archived at* http://perma.unl.edu/64B4-EWTC.

122. *Id.*

123. *Rule 2-4. Just and Equitable Principles of Trade*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=RULE%202-4&Section=4 (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/SC2E-ENMX. Currently, Compliance Rule 2-4 only refers to "commodity futures business." *Id.* But the NFA, in keeping with its post-Dodd-Frank Act role as the SRO for swap entities that must register with the CFTC, will likely update the rule in the future to include swaps. Additionally, NFA bylaws currently define "futures" to include exchange-traded options and leverage contracts, but not swaps. *See Rule 1-1. Definitions (p)*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=RULE%201-1&Section=4 (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/C9AU-3Q5S (definition of "futures").

124. *Interpretive Notice 9005*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx#5 (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/M3B4-3MRH.

125. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9769 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.433).

Compliance Rule 2-29(a) states that "[n]o Member or Associate shall make any communication with the public which: (1) operates as a fraud or deceit; (2) employs or is part of a high-pressure approach; or (3) makes any statement that futures trading is appropriate for all persons."[126] Compliance Rule 2-29(b) prohibits communications in promotional materials that, *inter alia*,

> (1) [are] likely to deceive the public; (2) contain[ ] any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material misleading; (3) mention[ ] the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; [or] (4) include[ ] any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results . . . .[127]

Compliance Rule 2-29(c) establishes guidelines for the use of hypothetical performance results, including required disclaimers.[128] Additionally, Compliance Rule 2-29(d) states that "[s]tatements of opinion included in promotional material must be clearly identifiable as such and must have a reasonable basis in fact."[129]

3. *NFA Interpretive Notices on the Customer Communications Rule*

i. *Interpretive Notice 9003—Section-by-Section Analysis of the Customer Communications Rule*

NFA issued Interpretive Notice 9003 in connection with the adoption of Compliance Rule 2-29 in 1985.[130] Interpretive Notice 9003 states that the NFA fulfills its responsibility under CEA section 17(p)(3) to establish minimum standards governing sales practices for its members by establishing Compliance Rules, "which, among other things, generally prohibit fraud and deceit and require Members and Associates to 'observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business.'"[131]

Interpretive Notice 9003 states, "Rule 2-29 is intended to apply to all communications with the public by a Member or Associate without exception if the communication relates in any way to the solicitation of

126. *Rule 2-29. Communications with the Public and Promotional Material*, *supra* note 114, at (a)(3). Compliance Rule 2-29(a)(3), like other NFA guidance, states that Members and Associates shall not "make[ ] any statement that futures trading is appropriate for all persons" without mentioning swaps. *Id.* The NFA likely will update its guidance to mention swaps, but, notwithstanding this omission, the NFA is the SRO for swap entities and other swap intermediaries that must register with the CFTC.

127. *Id.* § 2-29(b).

128. *Id.* § 2-29(c).

129. *Id.* § 2-29(d).

130. *Interpretive Notice 9003*, *supra* note 109.

131. *Id*.

an account, agreement or transaction in the conduct of the Member's or Associate's business in futures as the term 'futures' is now or may be defined."[132] Section (a) of Compliance Rule 2-29 covers "routine" or "day-to-day" communications with customers,[133] whereas section (b) of Rule 2-29 governs communications contained in "promotional material," which is interpreted broadly to cover "most communications with the public"[134] and includes, *inter alia*, websites, newspaper and magazine advertisements, direct mail, radio and television commercials, newsletters, seminars, sales scripts, cover letters, standardized phone solicitations, and email.[135] Interpretive Notice 9003 states that, under section (a) of Rule 2-29 (General Prohibition), "routine customer contact would not run afoul of Rule 2-29 as long as it is not fraudulent or deceitful, is not high-pressure in nature and does not contain any statement that futures trading is appropriate for all persons."[136] Interpretive Notice 9003 further stated that, in regard to Rule 2-29(a), routine communications do not "operate as a fraud or deceit in the

132. *Id.* The definition of the term, "futures" includes exchange-trade options. *Bylaw 1507. Definitions*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=BYLAW%201507&Section=3 (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/Y9DJ-F5NF. Article XVIII, for example, defines the term "futures" as "includ[ing] options contracts traded on a contract market, and such other commodity-related instruments as the Board may from time to time declare by bylaw to be properly a subject of NFA regulation and oversight." Article of Incorporation XVIII(k), *supra* note 101. Again, the NFA will probably update Compliance Rule 2-29—and the related Interpretive Notices—to mention swaps. *See id.* at art. XVIII(w) (defining the term "swaps" to mean "swaps as used and defined in the [CEA] and in the [CFTC] Rules, and such other swap-related agreement, contract or transaction as the Board may from time to time declare by [b]ylaw to be properly a subject of NFA regulation and oversight").

133. *Interpretive Notice 9003*, *supra* note 109; *A Guide to NFA Compliance Rules 2-29 & 2-36: Communications with the Public & Promotional Material*, NAT'L FUTURES ASS'N (Sep. 2010), http://www.nfa.futures.org/NFA-compliance/publication-library/compliance-rule-2-29.pdf, *archived at* http://perma.unl.edu/N9A2-VQSE [hereinafter *NFA Guide to Compliance*].

134. *Promotional Material*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfa-faqs/compliance-faqs/promotional-material/index.HTML (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/J9XK-9V8M (stating "except for routine day-to-day communications, most communications with the public are considered promotional material" in response to the question, "[w]hat is promotional material?").

135. *See Promotional Material*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/NFA-new-member/general-requirements/promotional-material.HTML (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/ZLG5-RNNL; *NFA Guide to Compliance*, *supra* note 133, at 4. "[D]ay-to-day communications are spontaneous communications that respond to a particular person's needs and concerns, while promotional material is prepared or thought out in advance." *Id.* at 8.

136. *Interpretive Notice 9003*, *supra* note 109.

absence of . . . intent or recklessness."[137] Interestingly, although the NFA has interpreted this provision as requiring proof of scienter, Compliance Rule 2-29(a)(1) mirrors language in CEA Section 4*o*(1)(B)[138] (covering fraud by commodity trading advisors and commodity pool operators) that federal courts have interpreted as *not* requiring scienter.[139]

In any event, the NFA has stated that scienter is *not* generally required to prove violations of section (b) of Compliance Rule 2-29, which governs the "Content of Promotional Material."[140] Interpretive Notice 9003 states that Compliance Rule 2-29(b)(1) prohibits the use of any promotional material that "is likely to deceive the public," which means that "[p]roof of violation of this provision does not require proof of a specific intent to deceive" because "[t]his Subsection instead places the burden on the Member to determine whether the material is likely to be deceptive in effect."[141] Interpretive Notice 9003 further states that "to find a violation of this subsection [one] would have to find that the Member or Associate reasonably should have been able to determine that the material was likely to deceive."[142] NFA guidance states that a negligence standard is appropriate for misleading communications in promotional material "because the Member or Associate has had the opportunity to think about the content of the material."[143]

Subsection (2) of Compliance Rule 2-29(b) prohibits Members and Associates from using promotional material that "contains any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material mislead-

137. *Id.* Although, importantly, "[a] communication may be deceptive or misleading even if no customer or potential customer is actually deceived." *NFA Guide to Compliance*, *supra* note 133, at 8.

138. CEA § 4*o*, 7 U.S.C. § 6*o* (2012) ("(1) It shall be unlawful for a commodity trading advisor, associated person of a commodity trading advisor, commodity pool operator, or associated person of a commodity pool operator, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . (B) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant.").

139. *See* Messer v. E.F. Hutton & Co., 847 F.2d 673, 677–80 (11th Cir. 1988) (stating that CEA section 4*o*(1)(B), 7 U.S.C. § 6*o*(1)(B) (2012), "does not require proof of scienter"); Commodity Trend Serv., Inc. v. Commodity Futures Comm'n, 233 F.3d 981, 993 (7th Cir. 2000) (stating that the language of CEA section 4*o*(1)(B) "focuses upon the effect a [commodity trading advisor's (CTA's)] conduct has on its investing customers rather than the CTA's culpability, and so does not require a showing of scienter").

140. *Interpretive Notice 9003*, *supra* note 109.

141. *Id*.

142. *Id*. *See NFA Guide to Compliance*, *supra* note 133, at 8.

143. *NFA Guide to Compliance*, *supra* note 133, at 4.

ing . . . ."[144] NFA Compliance Rule 2-29(b)(2)—along with Rule 2-29(b)(1)—invokes "a negligence standard" in connection with "material misstatements," but applies a "knowing" standard to omissions.[145] Specifically, one "can also be held responsible for factual omissions if the [person] knew about the omitted fact and the omission makes the promotional material misleading."[146] But once knowledge of the omitted fact is established, a reasonableness standard applies to determine whether the failure to include that fact makes the promotional material misleading.[147]

Subsection (3) of NFA Compliance Rule 2-29(b), which prohibits the use of promotional material that "mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss,"[148] "requires a statement of risk to 'balance' any discussion of the possibility of profit."[149] While "the statement of risk" must have "equal prominence," that does not "mean that the reference to risk must be as long as the discussion of the possibility of profit or . . . impose any unbending measure of prominence" because the objective of Rule 2-29(b)(3) is to ensure that "the reference to risk of loss [is not] downplayed or hidden."[150]

As the previous discussion illustrates, Interpretive Notice 9003 highlights one distinction regarding the state of mind required to prove that conduct violates Rule 2-29—a distinction that does not, to this date, appear to have a parallel in the CEA or in CFTC Regulations. Specifically, "routine" and "day-to-day" communications with customers are governed by Rule 2-29(a), which requires proof that the conduct at issue was intentional or reckless, whereas communications in "promotional material" are governed by Rule 2-29(b), which evaluates conduct on a "reasonableness" or negligence standard. Neither the CEA nor CFTC Regulations require a different state-of-mind for fraud claims depending on whether the communication at issue is

144. *Rule 2-29. Communications with the Public and Promotional Material*, supra note 114, § 2-29(b)(2).

145. *Interpretive Notice 9003*, *supra* note 109 ("This knowledge requirement [for omissions] may complicate the proof necessary to establish a violation of this Subsection. However, knowledge can be inferred from a pattern of failures to include a material fact, the omission of which makes the promotional material misleading.").

146. *NFA Guide to Compliance*, *supra* note 133, at 8.

147. *Interpretive Notice 9003*, *supra* note 109.

148. *Rule 2-29. Communications with the Public and Promotional Material*, supra note 114, § 2-29(b)(3).

149. *Interpretive Notice 9003*, *supra* note 109. *See* NFA *Guide to Compliance*, *supra* note 133, at 10–11 (discussing the obligation to balance the discussion of profit potential with a discussion of the risk of loss and addressing issues such as the font size used for each and the number of times potential profits are mentioned as compared to potential losses).

150. *Interpretive Notice 9003*, *supra* note 109.

"routine" or contained in "promotional material." More importantly, the fact that the NFA considers email to be "promotional material" appears to mean that potentially deceptive or misleading communications contained in email would be evaluated under a negligence standard, while the same communication in a telephone conversation would need to have been made intentionally or recklessly for liability to attach. If the CFTC were to adopt the NFA's framework for Compliance Rule 2-29 in determining the appropriate elements of a fair dealing rule claim, then negligently deceptive communications in emails and other "promotional materials" would violate Regulation 23.433. In any event, Interpretive Notice 9003 states that "[w]hether a communication is deceptive or misleading depends on the content and the overall impression it makes, regardless of whether it is a day-to-day communication or promotional material."[151]

ii. Interpretive Notice 9025—Hypothetical Performance Results

Interpretive Notice 9025 states that, "[o]ver the years the use of hypothetical performance results has repeatedly produced highly misleading promotional material," which is not surprising given that, "[b]y their very nature, such performance results have certain limitations."[152]

> For example, hypothetical performance results do not represent actual trading and are generally designed with the benefit of hindsight which may under- or over-compensate for the impact of certain market factors, including lack of liquidity and slippage. Furthermore, since hypothetical trading does not involve financial risk, no hypothetical performance results can completely account for the impact of certain factors associated with risk, including the ability of the customer or the advisor to withstand losses or to adhere to a particular trading program in the face of trading losses.[153]

The NFA forbids the use of hypothetical trading results "for any trading program for which the Member has three months of actual trading results."[154] The CFTC considered—but declined to adopt—a complete ban on the use of hypothetical performance results; instead, the CFTC requires persons who use hypothetical performance results to display the disclaimer set forth in CFTC Regulation 4.41.[155] Inter-

151. *Id.*
152. *Interpretive Notice 9025*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9025&Section=9 (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/EH2J-32N9.
153. *Id.*
154. *Id.*
155. *Id. See* 17 C.F.R. § 4.41 (2013), which contains the following disclaimer:

> These results are based on simulated or hypothetical performance results that have certain inherent limitations. Unlike the results shown in an actual performance record, these results do not represent actual trading. Also, because these trades have not actually been executed, these

pretive Notice 9025 states, however, that "[i]n NFA's experience . . . the use of the mandated disclaimer has not prevented recurring abuses in the presentation of hypothetical results."[156] For example, some "Members have effectively diminished the impact of the disclaimer by grossly over-emphasizing the significance of very dramatic hypothetical profits" by, *inter alia*, using "promotional material which presents hypothetical rates of return in large, bold face print while the disclaimer can be read only with a magnifying glass."[157] Similarly, "[i]n other advertising pieces the disclaimer is so far removed from the touted hypothetical profits that customers may never find it," and in other circumstances, "Members or Associates have attempted to disguise hypothetical performance results as actual performance results."[158] Interpretive Notice 9025 also noted that NFA Compliance Rule 2-29(c)(2) "requires Members advertising hypothetical results to disclose their actual results as well." Other parts of Rule 2-29(c) include specific disclaimers that Members and Associates must display in connection with promotional material that uses hypothetical performance results.[159] Members that use promotional material with hypothetical performance results must display NFA's required disclaimer "as prominently as the hypothetical results themselves" and "must also describe in the promotional material all of the material assumptions that were made in preparing the hypothetical results."[160]

iii. Interpretive Notice 9038—High-Pressure Sales Practices

NFA Compliance Rule 2-29(a)(2) prohibits "high-pressure sales practices" by Members and Associated Persons (APs). NFA Interpretive Notice 9038 provides information about the kinds of tactics that fall within that prohibition. Interpretive Notice 9038 states that "NFA Compliance Rule 2-29 governs Members' communications with the public and is one of the most important NFA rules in ensuring that Members observe high ethical standards in their dealings with

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results may have under-or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to these being shown.

156. *Interpretive Notice 9025*, *supra* note 152.
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* ("At a minimum, the description of material assumptions must cover points such as initial investment amount, reinvestment or distribution of profits, commission charges, management and incentive fees, and method used to determine purchase or sales prices for each trade.").

customers."[161] Interpretive Notice 9038 notes that, while Compliance Rule 2-29(a)(2) "does not define 'high-pressure sales practices' . . . there have been a significant number of NFA enforcement cases prosecuted under the rule, and those cases provide guidance to Members on the types of practices which have been found to constitute high-pressure sales practices."[162]

NFA Interpretive Notice 9038 states:

> A common trend in many of the high-pressure sales cases brought by the Business Conduct Committee is the sense of undue urgency which the associated person conveys to the customer. In essence, the AP is asking the customer to act now and think later. This approach can take several different forms. In some cases, the AP rushes the customer through the account opening forms, glossing over the risk disclosures in his haste to open the account. . . . In some cases, APs have actively attempted to dissuade unsophisticated customers from seeking further advice on their investment decision from friends, relatives or advisors or have tried to threaten or intimidate customers. The purpose of NFA's rule is to ensure that the customer makes a fully informed and carefully considered investment decision. Any tactic, such as those outlined above, which presses a customer for a hasty decision will be considered a violation of NFA Compliance Rule 2-29(a)(2).[163]

Interpretive Notice 9038 indicates that "[a]nother familiar theme in NFA's high-pressure sales cases involves a pattern of telephone calls which are unusual in their timing or frequency."[164] Examples of such tactics include situations where an AP "barraged the customer with calls either late at night or early in the morning" and where "the AP's telephone solicitations to open an account occurred several times a day, several days a week for weeks on end."[165] Additionally, "[p]erhaps the most obvious indicator of a high-pressure sales practice is simply the tone used by the AP to address the customer."[166] Notably, "[i]n a handful of cases, APs have shouted at customers, used profane language or otherwise berated the customer in an attempt to bully a customer into opening an account," all of which "clearly violates NFA rules."[167]

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161. *Interpretive Notice 9038*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9038&Section=9 (last visited Feb. 17, 2014), *archived at* http://perma.unl.edu/X3GB-RTYJ.

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.* ("Phone calls made at unusual hours and with unusual frequency, unless at the customer's request, can be an abusive practice, designed to abuse, annoy or harass a customer into opening an account and constituting a violation of NFA Compliance Rules.").

166. *Id.*

167. *Id.* Interpretive Notice 9038 also states that "[t]his notice cannot and is not intended to alert Members to all of the factors that may constitute a high-pressure sales practice." *Id.*

iv. Interpretive Notice 9039—Radio and Television Advertisements

While Interpretive Notice 9038 sheds light on what constitutes "high-pressure sales practices," NFA Interpretive Notice 9039 addresses communications by NFA Members in radio and television advertisements.[168] Interpretive Notice 9039 states, "[a]mong other things, [Rule 2-29] prohibits the use of promotional material which is misleading or deceptive" and "[t]he purpose of this rule is to protect the public from fraudulent advertising and sales solicitations and to provide guidance to Members on the standards by which their promotional material will be evaluated."[169] Interpretive Notice 9039 states that the NFA's Board was "concerned with several types of misleading radio and television advertisements" whose "consistent theme is that customers are likely to make substantial profits by following the sponsoring firm's recommendations."[170]

Interpretive Notice 9039 provides examples of the kind of tactics used in the misleading advertisements, including the following: (1) "ads [that] cite seasonal data which supposedly shows that certain trades produce dramatic profits year in and year out in such products as heating oil in the winter and unleaded gas in the summer;" (2) ads that mention historic price moves that suggest that a previous "record setting [price] move is likely to occur again;" (3) "ads [that] highlight the tremendous profits which will result from projected price movements which are characterized, directly or indirectly, as conservative estimates when, in fact, such price movements would be dramatic;" (4) "ads [that] use price data for a product different from the one being marketed in the promotional material," such as "ads that use pricing data relative to the cash or futures markets to sell options;" (5) "ads [that] claim that customers can turn a $10,000 investment into $25,000 or make similar types of dramatic profit projections;" (6) "ads [that] seek to entice prospective investors by claiming that their customers have made dramatic profits; however, such claims rely on isolated trades in specific customer accounts" (i.e., on "'cherry picked' trades"); and (7) "ads [that] improperly use 'leverage examples' as a means of suggesting that prospective customers are likely to earn large profits trading futures and options."[171]

168. *Interpretive Notice 9039*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9039&Section=9 (last visited Feb. 18, 2014), *archived at* http://perma.unl.edu/64LB-YU96.

169. *Id.*

170. *Id.*

171. *Id.* NFA Interpretive Notice 9039 seems to combine information from two earlier notices, namely, NFA Interpretive Notices 9033 and 9034. *See Interpretive Notice 9033*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9033&Section=9 (last visited Feb. 18, 2014), *archived at* http://perma.unl.edu/52YV-AH4X (addressing some, but not all, of the same kinds of

Interpretive Notice 9039 further states, "this list of deceptive advertising techniques is not all inclusive" and "[e]ach of the practices described above presents a distorted and misleading view of the likelihood of customers earning dramatic profits by investing with the Member, and each of these practices represents a clear violation of NFA's sales practice rules."[172] Indeed, an earlier notice—NFA Interpretive Notices 9033—which addresses some of the exact same kinds of sales practices described in Notice 9039, states that "[a]ny Member making the types of claims referred to above must be able to demonstrate to the NFA upon request that the actual performance of its customers supports these claims" and "[f]ailure to provide adequate documentation will constitute prima facie evidence that the promotional material is misleading."[173]

v. Interpretive Notice 9043—Examples of Violative Conduct

NFA Interpretive Notice 9043 states that "NFA Compliance Rule 2-29 imposes high standards on Members' and Associates' communications with the public in connection with their futures activities."[174] Notice 9043 further states that the following kinds of statements in promotional material violate Rule 2-29(b)(1) and (2):

(1) Using outdated information to support current claims;

(2) Making claims regarding research or other facilities beyond those which the Member or Associate actually possesses or has reasonable capacity to provide;

(3) Stating that a report, analysis, or other service will be furnished free unless such report, analysis or other service actu-

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tactics; namely, (1) claims regarding seasonal trades, (2) claims regarding historic price moves, (3) "cherry picked" trades, and (4) profit projections); *Interpretive Notice 9034*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9034&Section=9 (last visited Feb. 18, 2014), *archived at* http://perma.unl.edu/D7CJ-ATG6 (addressing deceptive sales practices involving mention of "mathematical examples of leverage" and "using price moves for one product to solicit investors for a different product").

172. *Interpretive Notice 9039*, *supra* note 168.

173. *Interpretive Notice 9033*, *supra* note 171 ("Members may not engage in a pattern of advertising or solicitation which makes reference to dramatic profits which could be achieved in the future or could have been achieved in the past . . . unless the Member can demonstrate to NFA that, based on the past performance of customers, those claims are not misleading.").

174. *Interpretive Notice 9043*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9043&Section=9 (last visited Feb. 18, 2014), *archived at* http://perma.unl.edu/WEZ7-2D5C. Interpretive Notice 9043 addresses entities involved with security futures which, pursuant to the Commodity Futures Modernization Act (CFMA) of 2000, are jointly regulated by the CFTC and SEC. *Id.*

ally is or will be furnished entirely free and without condition.[175]

Notably, NFA Interpretive Notice 9043 states that, under Rule 2-29, the use of past performance results in promotional material must meet the following requirements (among others): (1) "[past performance results] must be presented in a balanced manner," (2) "[p]romotional material must disclose all relevant costs, including commissions and fees," and (3) "[f]or security futures products, the promotional material must indicate the general market conditions during the period covered."[176] Further, Interpretive Notice 9043 states that Compliance Rule 2-29 requires that the use of projected performance results in promotional material "have a reasonable basis in fact," identify "[a]ll material assumptions," and include a discussion of the risks that is "balanced with the discussion of projected profits."[177]

B. Lessons from NFA Guidance for Regulation 23.433

Analysis of the External Business Conduct Standards rule releases and relevant NFA guidance appears to provide a few insights into Regulation 23.433. Most notably, in stating that a swap entity must communicate in a fair and balanced manner based on principles of good faith and fair dealing, each part of the previous clause is not a separate element that the CFTC must prove to state a cause of action under the fair dealing rule. Both the proposing and adopting releases for the External Business Conduct Standards speak broadly about the kind of communications prohibited by Regulation 23.433 without regard to whether a particular communication is, for example, unfair but balanced or fair but unbalanced. Similarly, the CFTC did not, in its rulemaking, describe factors that would constitute violations of

175. *Id*. These kinds of statements also generally are considered violations of pre-Dodd-Frank Act antifraud provisions of the CEA. *See* Commodity Futures Trading Comm'n v. Fitzgerald, 310 F.3d 1321, 1330 (11th Cir. 2002) ("This recklessness is premised on the fact that this Court and the CFTC have previously condemned attempts to attract customers by: (1) linking profit expectations on commodities options to known and expected weather events, seasonal trends, and historical highs; (2) suggesting that the commodities market can be correctly timed to generate large profits; and (3) substantially inflating profit expectations while downplaying risk of loss."); Commodity Futures Trading Comm'n v. Brickell Key Fin. L.L.C., No. 04-22549-CIV, 2006 WL 5105621, at *6 (S.D. Fla. July 14, 2006) (sales material that "made references to dramatic historical price moves with a suggestion that the same dramatic move is likely to occur again" were fraudulent because "they sought to persuade readers into believing that profits could be generated in the futures markets based upon known and expected events" and thereby "unreasonably exaggerate[d] the likelihood of profits in a short period of time without presenting a balanced picture of potential risks").

176. *Interpretive Notice 9043*, *supra* note 174.

177. *Id*.

principles of good faith, as opposed to fair dealing. Likewise, the applicable NFA Compliance Rules and Interpretive Notices do not describe specific circumstances that would make a communication unfair as distinct from unbalanced. Therefore, those terms—fair, balanced, good faith, and fair dealing—do not appear to constitute separate elements under Regulation 23.433. Instead, Regulation 23.433 appears to prohibit unfair communications generally, with NFA guidance providing a source of content for the duty of fair dealing.

Next, if the fair dealing rule incorporates concepts from NFA guidance, then Regulation 23.433 potentially reaches beyond existing prohibitions of improper conduct under the CEA and CFTC Regulations in three ways. First, while some communications prohibited by Compliance Rule 2-29 likely would violate pre-Dodd-Frank Act antifraud provisions in the CEA, the prohibition against non-fraudulent, high-pressure sales practices is a prohibition that other CEA provisions or CFTC Regulations do not appear to cover. Therefore, this represents an area where the fair dealing rule—to the extent that it incorporates Compliance Rule 2-29's ban on high-pressure sales practices—could provide additional protection to swap counterparties. Second, Compliance Rule 2-29 appears, in some circumstances, to place the burden on the *defendant* to prove that statements in promotional material—such as solicitations stating that prospective customers could achieve dramatic profits in the future or could have achieved such profits in the past—are warranted or accurate.[178] This approach does not appear to have a corollary in CEA provisions or CFTC Regulations.

Third, unlike Compliance Rule 2-29(b), the CEA and CFTC Regulations do not prohibit negligent misrepresentations in promotional material, a term that is broadly interpreted to include a wide swath of sales communications, from emails to advertisements. Indeed, other than CEA section 4*o*(1)(B)[179] and two of the abusive practices rules (Regulation 23.410(a)(2) and (3)),[180] the CEA and CFTC Regulations generally require a proof of scienter (recklessness or intent) in connection with fraud claims.[181] As such, to the extent that the fair dealing rule is interpreted as mimicking the NFA's prohibition against negligent misrepresentations in promotional material, Regulation 23.433 would provide a potentially more expansive remedy against fraud in

178. *See Interpretive Notice 9033*, *supra* note 171.
179. 7 U.S.C. § 6*o*(1)(B) (2012).
180. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9753 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.410(a)) (discussing non-scienter antifraud provisions of Regulation 23.410(a)).
181. For example, claims based on the primary antifraud provision of the CEA, section 4(b), 7 U.S.C. § 6(b) (2012), require proof of scienter. *See* Commodity Futures Trading Comm'n v. Fitzgerald, 310 F.3d 1321, 1328 (11th Cir. 2002).

promotional material than existing statutory and regulatory provisions. Unfortunately, the proposing and adopting releases for the External Business Conduct Standards do not provide guidance as to the state of mind necessary to prove a violation of Regulation 23.433. Thus, without more, there is no clear answer as to the necessary mental state for a claim under Regulation 23.433.

IV. INVESTMENT BANK MISCONDUCT DETAILED IN THE U.S. SENATE'S *ANATOMY OF A FINANCIAL COLLAPSE*

A comment period followed the CFTC's December 22, 2010 publication in the *Federal Register* of its Proposed External Business Conduct Standards. Likewise, the SEC—which published its own Proposed External Business Conduct Standards for security-based swap dealers and major security-based swap participants in the *Federal Register* on July 18, 2011—also had a comment period on its proposals. On August 29, 2011, the Consumer Federation of America (CFA) and Americans for Financial Reform (AFR) submitted a joint comment letter to the SEC (CFA/AFR Letter).[182] While the CFA/AFR Letter commented on the SEC's Proposed External Business Conduct Standards, the letter also referenced the CFTC's Proposed External Business Conduct Standards.[183]

U.S. Senator Carl Levin also sent a comment letter to the SEC (Senator Levin's Letter) on August 29, 2011.[184] Senator Levin's Letter stated that the U.S. Senate's Permanent Subcommittee on Investigations, in compiling information for the Senate Report, "examined the role of investment banks in the financial crisis, exploring how Goldman Sachs ['Goldman'] and Deutsch Bank[185] ['Deutsche'] structured, marketed, and sold high risk, poor quality mortgage products to investors."[186] Senator Levin urged the SEC to draft its Final External Business Conduct Standards in a manner that would enable the SEC to prohibit the kinds of improper investment bank activities referenced in the Senate Report.[187] Notably, Senator Levin's Letter con-

182. *See* Letter from Barbara Roper et al., on behalf of the CFA and AFR, to Elizabeth M. Murphy, Sec'y of the SEC (Aug. 29, 2011) [hereinafter CFA/AFR Letter], *archived at* http://perma.unl.edu/HS86-TXUW.
183. *See id.* at 6.
184. Letter from Carl Levin, U.S. Senator, to Elizabeth M. Murphy, Sec'y of the SEC (Aug. 29, 2011) [hereinafter Sen. Levin Letter], *archived at* http://perma.unl.edu/E5AX-UGH9.
185. Senator Levin's letter misspelled Deutsche Bank's name. *Id.* at 2.
186. *Id.*
187. *See id.* at 2–11 (citing STAFF, SENATE REPORT, *supra* note 8). The CFTC's External Business Conduct Standards adopting release did not describe the Senate Report in detail. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9759 n.357 (Feb. 17, 2012).

cluded with a section labeled, "Duty to Communicate in a Fair and Balanced Manner,"[188] which stated that the SEC's proposed fair dealing rule[189] was "[c]onsistent with the express text of the statute," because, in "track[ing] longstanding principles of exchanges and other self-regulatory organizations, [the proposed rule was] strongly supported by the Subcommittee's work, which found many instances of misleading and inaccurate communications by [security-based swap] dealers to investors."[190] Senator Levin concluded his discussion of the SEC's proposed fair dealing rule with the following:

> [T]o be fair and balanced, communications from [a security-based swap] entity must inform investors of both the potential rewards and risks of their investments, and the entity's own involvement and interests in the investments, in specific terms. All material adverse interests must be disclosed and communicated. The proposed rules should also make clear that it is not enough to inform a customer that the [security-based swap] entity 'may' have an adverse interest if that adverse interest already exists.[191]

Although addressed to the SEC, the CFA/AFR Letter and Senator Levin's Letter became part of the record for the CFTC's External Business Conduct Standards rulemaking.[192] The two letters are worth noting because, in adopting its External Business Conduct Standards, the CFTC specifically referred to the CFA/AFR Letter and Senator Levin's Letter in discussing the type of conduct that would be captured by the CFTC's fair dealing rule.[193] In particular, the CFTC stated that its Regulations—including the fair dealing rule—would prohibit the kind of conduct outlined in the Senate Report.[194] For example, the CFTC's adopting release stated:

> The [CFTC] intends these rules to address the concerns raised by commenters regarding transactions similar to those profiled in the Senate Report. The Senate Report concludes that those transactions, which involved structured

188. Sen. Levin Letter, *supra* note 184, at 10.

189. Although the SEC has not finalized its fair dealing rule, it is adopting the same approach as the CFTC. Both agencies stated that their fair dealing rules would incorporate industry standards of fairness from their respective SROs. In the CFTC's case, the relevant SRO is NFA; with the SEC, it is FINRA. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 42,418–19 (proposed July 18, 2011).

190. Sen. Levin Letter, *supra* note 184, at 10.

191. *Id.* at 11.

192. The letters were submitted to the CFTC for consideration during "external meetings." *See Business Conduct Standards with Counterparts*, COMMODITY FUTURES TRADE COMMISSION, http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_3_BusConductStandardsCP/index.htm (last visited Feb. 21, 2014), *archived at* http://perma.unl.edu/5LUN-LUB2, for a list of all submissions in connection with the CFTC's External Business Conduct Standards.

193. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9759 & n.357, 9760–61 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.410(a)) (citing, *inter alia*, the Aug. 29, 2011 CFA/AFR Letter and the Sen. Levin Letter).

194. *See id.* at 9759 n.357.

> CDOs, were problematic because they were designed to fail and the disclosures omitted and/or misrepresented the material risks, characteristics, incentives and conflicts of interest. *Under all circumstances, and particularly those akin to the Senate Report involving complex swaps, the [CFTC]'s fair dealing rule will apply and operate as an independent basis for enforcement proceedings.*[195]

Likewise, another section of the adopting release stated:

> Without commenting on the Senate Report's findings, the [CFTC] considered how the final disclosure rules would address transactions similar to those profiled in the Senate Report, as requested by commenters. The final rule addresses the types of concerns raised by the Senate Report and by commenters by requiring the disclosure of material risks, characteristics, incentives and conflicts of interest, *as well the duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith*.[196]

Because the CFTC stated that the fair dealing rule, either by itself or with other External Business Conduct Standards, would cover the improper conduct discussed in the Senate Report, a closer look at that conduct should provide context for the fair dealing rule.

A. Deutsche Bank

In examining the activities Deutsche Bank, the Senate Report primarily scrutinized the activities of the bank's top CDO trader, Greg Lippmann, who "repeatedly warned and advised his Deutsche Bank colleagues and some of his clients seeking to buy short positions[197] about the poor quality of the [residential mortgage back securities (RMBSs)][198] underlying many CDOs, describing some of those securities as 'crap' and 'pigs.'"[199] Portions of the Senate Report describe Mr. Lippmann's actions in connection with a CDO named Gemstone CDO VII Ltd. (Gemstone 7). Gemstone 7, which issued its securities in

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195. *Id.* at 9769 (emphasis added) (citing, inter alia, Staff, Senate Report, *supra* note 8, at 376–636). CDOs, like other debt securities, are regulated by the SEC. FCIC, Final Report *supra* note 3, at 170.
196. *Id.* at 9760–61 (emphasis added). As mentioned above, the disclosure rules contained in the CFTC's External Business Conduct Standards also would likely serve to prohibit some of the types of behavior outlined in the Senate Report. *See id.* at 9768 n.477 (citing Staff Senate Report, *supra* note 8, at 509–10) (stating that "the [CFTC] notes that the Senate Report included descriptions of certain conduct relating to marks where dealers purportedly refused to explain the basis and methodology for the mark").
197. A short position is worth more if the derivative decreases in value; a long position increases in value as the derivative increases in value. *See* George Kleinman, Trading Commodities and Financial Futures, at xxiv, 7–8 (3d. ed. 2005).
198. "[Residential mortgage backed securities ('RMBS')] and mortgage-based CDOs are debt obligations based on large pools of mortgage loans whose cash flows are based on principal and interest payments from the underlying mortgages." Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 Iowa L. Rev. 1575, 1582 n.17 (2013). *See also* FCIC, Final Report *supra* note 3, at 73 (describing how RMBSs are created).
199. Staff Senate Report, *supra* note 8, at 319, 330.

March 2007, was a "hybrid CDO containing or referencing a variety of high risk, subprime RMBS securities initially valued at $1.1 billion when issued."[200] Mr. Lippmann "disparaged RMBS securities that, at the same time, were being included in Gemstone 7, a CDO being assembled by the bank for sale to investors."[201] "Deutsche Bank sold $700 million in Gemstone securities to eight investors who saw their investments rapidly incur delinquencies, rating downgrades, and losses."[202] "The Deutsche Bank sales force aggressively sought purchasers for the CDO securities while certain executives expressed concerns about the financial risk of retaining Gemstone 7 assets as the market was deteriorating in early 2007."[203] "Deutsche Bank allowed the inclusion of Gemstone 7 assets which its most senior CDO trader was asked to review and saw as likely to lose value."[204] "[T]he bank sold poor quality assets from its own inventory to the CDO" and "aggressively marketed the CDO securities to clients despite the negative views of its most senior CDO trader, falling values, and the deteriorating market."[205] Indeed, Deutsche Bank executives pushed its sales force to sell Gemstone 7 securities as soon as possible because they "were well aware of the worsening CDO market and were rushing to sell Gemstone 7 before the market collapsed."[206] Additionally, "the bank failed to inform potential investors of Mr. Lippmann's negative views of the underlying assets and its inability to sell over a third of Gemstone's securities."[207]

B. Goldman

When bankers at Goldman saw that the value of RMBSs and CDOs were declining as a result of record homeowner defaults, Goldman continued peddling them rather than advise clients to stay away from such financial products. Meanwhile, Goldman took positions in CDSs that allowed Goldman to profit in the event that the RMBSs and CDOs that they were selling declined in value.[208] The Senate Report stated that Goldman's "abuses included pricing the swaps higher than its internal valuations, refusing to provide investors with its pricing methodology and scenarios, and presenting investors with bid-offer spreads that had little relation to the firm's

200. *Id.* at 331.
201. *Id.* at 320.
202. *Id.*
203. *Id.* at 331.
204. *Id.* at 375. "While the Gemstone CDO was constructed and marketed by the bank's CDO Desk, which is separate from the trading desk controlled by Mr. Lippmann, both desks knew of Mr. Lippmann's views." *Id.* at 374.
205. *Id.* at 375.
206. *Id.* at 366.
207. *Id.* at 375, 360–61.
208. *Id*. at 523–26.

internal valuations."[209] The Senate Permanent Subcommittee on Investigations "uncovered significant evidence of unsuitable recommendations made by investment banks, essentially urging investors to buy security-based swaps that the investment bank expected or knew were designed to lose value."[210] The Senate Report further stated the following:

> The evidence discloses troubling and sometimes abusive practices which show, first, that Goldman knowingly sold high risk, poor quality mortgage products to clients around the world, saturating financial markets with complex, financially engineered instruments that magnified risk and losses when their underlying assets began to fail. Second, it shows multiple conflicts of interest surrounding Goldman's securitization activities, including its use of CDOs to transfer billions of dollars of risk to investors, assist a favored client make a $1 billion gain at the expense of other clients, and produce its own proprietary gains at the expense of clients to whom Goldman sold its CDO securities.[211]

Goldman "was keenly aware of the poor quality of many of the loan pools in its warehouse accounts" but "[n]evertheless, during this time period, Goldman continued securitizing many of those loans and selling the resulting RMBS securities to clients."[212]

1. *Hudson*

For example, "in the fall of 2006, Goldman assembled Hudson Mezzanine 2006-1 ('Hudson'), a $2 billion synthetic CDO[213] that refer-

209. Sen. Levin Letter, *supra* note 184, at 6.
210. *Id.* at 9.
211. STAFF, SENATE REPORT, *supra* note 8, at 476.
212. *Id.* at 487.
213. A "synthetic CDO" can be described as follows:

> A synthetic security is a derivatives contract in which payments to and from each counterparty mimic, simulate, or are a function of the costs and returns of an actual security or a pool of securities. For example, a synthetic collateralized debt obligation ("synthetic CDO") is a derivatives contract in which the payoffs between the counterparties are based on how a pool of reference CDOs, mortgage-backed securities, and/or other debt instruments actually perform. The mechanical process of translating the performance of these debt instruments into a synthetic CDO is typically accomplished by first creating one or more credit derivatives, such as credit default swaps, each referencing one or more debt instruments, and then pooling these credit derivatives into a collateralized debt obligation. In other words, the underlying of a synthetic CDO is typically a single, or a pool of, credit derivatives and thus, a credit derivative itself.

Lynch, *supra* note 4, at 27 n.96. "[Credit default swaps] were essential to the creation of synthetic CDOs. These synthetic CDOs were merely bets on the performance of real mortgage-related securities." FCIC, FINAL REPORT, *supra* note 3, at xxiv.

enced subprime[214] [RMBSs]" as a way for Goldman to benefit from its prediction that subprime RMBSs would soon decline in value.[215]

> These assets were placed on the balance sheet of an offshore shell corporation via a credit default swap (CDS), and then marketed to investors. Although Goldman provided vague and generalized risk factors, it failed to inform investors that the CDO was specifically designed to remove risky underlying assets from Goldman's balance sheet and to produce profits for the firm from shorting the referenced RMBS assets. Goldman's clients ended up losing nearly $1.7 billion from their investments in Hudson.[216]

Notably, "Goldman structured the [Hudson] CDO itself, transferring $1.2 billion of its own risk to investors while telling potential investors that Hudson was 'not a balance sheet CDO' and was 'sourced from the Street.'"[217] Even more, "Goldman held 100 percent of the short side of the CDO, meaning that in the event of widespread default on the referenced assets, the Hudson shell corporation set up by Goldman as the legal issuer of the securities would stop making payments to investors and start making payments to Goldman using investors' funds" because "[t]he CDO represented a zero-sum transaction" in which "either Goldman or the investors made money, but not both."[218] Senator Levin, in describing the transaction, wrote that "Goldman then marketed and sold this CDO to potential investors, telling them that it had 'aligned' its interests with investors and mentioning that it held a $6 million equity share while simultaneously failing to disclose that it was shorting all $2 billion of Hudson's assets."[219]

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214. "Subprime mortgages" refers to mortgages "to borrowers who had yet to establish credit histories or had troubled financial histories, sometimes reflecting setbacks such as unemployment, divorce, medical emergencies, and the like." FCIC, FINAL REPORT, *supra* note 3, at 67. "Banks might have been unwilling to lend to these borrowers, but a subprime lender would if the borrower paid a higher interest rate to offset the extra risk." *Id.* Accordingly, RMBSs and CDOs based on pools of subprime mortgages, not only filled the need for mortgages to put into credit derivatives, but also paid higher returns. *Id.* at 130 ("Investors liked the combination of apparent safety and strong returns, and investment bankers liked having a new source of demand for the lower tranches of mortgage-backed securities and other asset-backed securities they created."). *See also* 156 CONG. REC. S3,155 (daily ed. May 4, 2010) (statement of Sen. Franken) ("As we all know, subprime mortgages are riskier than regular mortgages. That is why they are called subprime. Borrowers are more likely to default.").

215. Sen. Levin Letter, *supra* note 184, at 3; *see* STAFF, SENATE REPORT, *supra* note 8, at 384–85, 390–92, 517–18.

216. Sen. Levin Letter, *supra* note 184, at 3; *see* STAFF, SENATE REPORT, *supra* note 8, at 518–31.

217. Sen. Levin Letter, *supra* note 184, at 3; STAFF, SENATE REPORT, *supra* note 8, at 517–18, 525; *see* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9766 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.431(a)(3)).

218. Sen. Levin Letter, *supra* note 184, at 4.

219. *Id.*; STAFF, SENATE REPORT, *supra* note 8, at 525–26, 531.

Additionally, Senator Levin's letter stated the following:

> The marketing materials contained a section entitled, 'Certain Conflicts of Interest' that stated that 'GSI [the Goldman affiliate involved in Hudson] and/or any of its affiliates may invest and/or deal' in securities or other interests in the assets underlying Hudson, and 'may invest and/or deal' in CDS contracts that are 'linked to' the Hudson investments. By the time these materials were circulated, however, Goldman had already decided to keep 100 percent of Hudson's short side. Thus, the marketing material misrepresented Goldman's investment plans, and the extent of Goldman's adverse interests in Hudson was not known to the investors that it solicited. Ultimately, the Hudson CDO enabled Goldman to earn a gross profit of $1.7 billion at the direct expense of its clients.[220]

Further, as Hudson's liquidation agent, Goldman promised to liquidate any Hudson asset determined to be a credit risk, but despite urgent requests from Hudson investors, Goldman delayed liquidating assets for months, thereby maximizing profits from its short position while exacerbating the losses to investors.[221]

2. *Anderson*

Anderson Mezzanine 2007-1 (Anderson) was a synthetic CDO referencing BBB and BBB- rated subprime RMBSs that Goldman issued in March 2007.[222] Anderson referenced poor quality assets that another firm selected, subject to Goldman's approval.[223] Goldman took a short position on approximately 40 percent of the $305 million in assets underlying Anderson.[224] About 45 percent of the underlying mortgages had been originated by New Century, a longtime Goldman customer that was, at the time of the deal, "in financial distress."[225] Goldman almost canceled the CDO because the underlying assets were decreasing in value, but never disclosed that fact to investors.[226] Goldman also did not disclose its own internal concerns about the quality of the mortgages that were the CDO's reference assets.[227]

> When potential investors asked how Goldman was able to 'get comfortable' with the New Century mortgage pools referenced in Anderson, Goldman attempted to dispel concerns about the New Century loans, withheld information about its own discomfort with New Century, and withheld that it was taking 40% of the short side of the CDO, essentially betting against the very securities it was selling to its clients.[228]

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220. Sen. Levin Letter, *supra* note 184, at 4, 9; STAFF, SENATE REPORT, *supra* note 8, at 391, 517, 527.
221. Sen. Levin Letter, *supra* note 184, at 5; STAFF, SENATE REPORT, *supra* note 8, at 392, 583–88.
222. STAFF, SENATE REPORT, *supra* note 8, at 392, 532.
223. *See id.* at 354–55, 392.
224. *See id.*
225. *Id*. at 534.
226. *Id.* at 535–36, 538.
227. *Id.* at 538.
228. *Id.* at 541.

3. Timberwolf

Timberwolf I (Timberwolf) was a $1 billion hybrid CDO^2 (CDO-squared)[229] transaction that referenced single-A rated securities from other CDOs, and those securities referenced RMBSs carrying lower credit ratings.[230] Goldman hired another firm to select Timberwolf's assets with Goldman's approval.[231] Goldman took a short position on approximately 36 percent of the $1 billion in assets underlying Timberwolf.[232] The underlying mortgage assets in Timberwolf were losing value as Goldman was constructing Timberwolf.[233] Goldman made selling Timberwolf securities one of its sales force's top priorities.[234] Goldman sold Timberwolf securities at higher prices than Goldman knew they were worth, refused to provide pricing methodologies to investors who requested them, and marked their value down substantially days or weeks after they were sold.[235]

> Timberwolf was issued in March 2007, when concerns about declining mortgage assets caused Goldman to rush Timberwolf to market. By May 2007, Goldman believed the value of the assets referenced in Timberwolf had fallen significantly and conducted an extensive revaluation of that and other CDOs. The results of this valuation project indicated that the Timberwolf prices should be dramatically lower. However, Goldman did not provide notice to clients, either directly or through the Timberwolf shell corporation, that the [security-based swaps] underlying Timberwolf had lost significant value. Rather, Goldman continued to market [Timberwolf security-based swaps] at inflated prices.[236]

Troublingly, "[t]hroughout the period in which it sold Timberwolf, Goldman consistently refused to provide investors with its pricing methodology, data scenarios, or specific marks for the securities it marketed."[237] Indeed, Goldman told its sales force that

229. *Collateralized Debt Obligation Squared—CDO-Squared*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cdo2.asp (last visited Feb. 18, 2014), *archived at* http://perma.unl.edu/Q2QH-DS22 ("A collateralized debt obligation squared (CDO-squared) is backed by a pool of collateralized debt obligation (CDO) tranches. . . . This is identical to a CDO except for the assets securing the obligation. Unlike the CDO, which is backed by a pool of bonds, loans and other credit instruments; CDO-squared arrangements are backed by CDO tranches. CDO-squared allows the banks to resell the credit risk that they have taken in CDOs."); *see* Robert F. Weber, *Structural Regulation as Antidote to Complexity Capture*, 49 AM. BUS. L.J. 643, 730 (2012) ("At the tail end of the credit bubble, CDO-squared and CDO-cubed transactions, involving CDOs of CDOs of CDOs, gained popularity.").

230. STAFF, SENATE REPORT, *supra* note 8, at 393, 541.

231. *Id.* at 393.

232. *Id.* at 393, 541–42.

233. *Id.* at 543.

234. *Id.* at 543–44.

235. Sen. Levin Letter, *supra* note 184, at 6.

236. *Id.*; STAFF, SENATE REPORT, *supra* note 8, at 393–94, 544–48, 552–54, 557–59.

237. Sen. Levin Letter, *supra* note 184, at 7.

> under no circumstances are we going to be able to provide materials specific to Timberwolf . . . or even use the word 'mark' in written materials . . . . Everything will be described in general terms, and if what we provide is too vague or general, the medium for further clarification must be oral, not written.[238]

Goldman's refusal to provide written information concerning its pricing and valuation methodology frustrated some clients, with "[i]nvestors often ask[ing] for pricing and valuing information, seeking additional information to understand the daily marks assigned to their swap holdings."[239] For example, one investor asked, "How many times do we have to request data points and scenarios by email. . . . I am getting weary of continually hearing about transparency and yet an obvious avoidance of 'putting things to paper.'"[240]

4. *Abacus*

"Abacus 2007-AC1 (Abacus) was a $2 billion synthetic CDO that referenced BBB rated mid and subprime RMBS securities issued in 2006 and early 2007."[241] Goldman did not itself invest in Abacus but earned fees structuring, underwriting, and administering the CDO.[242]

> Goldman originated Abacus 2007-AC1 in response to a request by Paulson & Co. Inc. ('Paulson'), a hedge fund that was among Goldman's largest customers for subprime mortgage related assets. Paulson had a very negative view of the mortgage market, which was publicly known, and wanted Goldman's assistance in structuring a transaction that would allow it to take a short position on a portfolio of subprime mortgage assets that it believed were likely to perform poorly or fail. Goldman allowed Paulson to use the Abacus CDO for that purpose. In entering into that arrangement with Paulson and simultaneously acting as the placement agent responsible for marketing the Abacus securities to long investors, Goldman created a conflict of interest between itself and the investors it would be soliciting to buy the Abacus securities.[243]

Goldman knew Paulson's investment objective, the role that Paulson played in the selection of the reference assets, and the fact that Paulson's selection process yielded a set of poor quality assets that were likely to decline in value.[244] "Yet Goldman did not publicly disclose the central role played by Paulson in the asset selection process or the fact that the economic interest held by an entity actively involved in the asset selection process was adverse to the interest of investors would be taking the long position."[245] The Abacus securities—

238. *Id.*; *see* STAFF, SENATE REPORT, *supra* note 8, at 509–10.
239. Sen. Levin Letter, *supra* note 184, at 7.
240. *Id.*; *see* STAFF, SENATE REPORT, *supra* note 8, at 559 (internal quotation mark omitted).
241. STAFF, SENATE REPORT, *supra* note 8, at 395, 560.
242. *Id.* at 396.
243. *Id.* at 396, 561–62.
244. *Id.* at 377, 396, 564–67.
245. *Id.* at 396, 564–65. Paulson had a strong influence on the selection of assets, with an eye toward selecting mortgage assets that would perform poorly. *Id.* at 566–67.

which are worthless today—lost their value soon after purchase, with the three long investors together losing more than $1 billion, while Paulson, the sole short investor, receiving about $1 billion in profits.[246] On April 16, 2010, the SEC filed a complaint against Goldman and one of the lead salespeople for the Abacus CDO, Fabrice Tourre, alleging they had failed to disclose materially adverse information to potential investors and thereby committed securities fraud.[247] On July 14, 2010, Goldman reached a settlement with the SEC in which Goldman admitted that the "marketing materials" "contained incomplete information" and agreed to pay a $550 million fine.[248] Mr. Tourre did not settle with the SEC, and he ultimately lost at trial on August 1, 2013, with a jury finding that he had misled investors in connection with the Abacus CDO.[249]

V. POTENTIAL SOURCES OF GOOD FAITH PRINCIPLES FOR THE FAIR DEALING RULE

A. Contract Law's Implied Covenant of Good Faith and Fair Dealing

Principles of good faith have been—and continue to be—invoked in many different areas of the law, such as statutes[250] and in decisional

246. *Id.* at 396–97, 573–74.
247. *Id.* at 397.
248. *Id.* "[I]t is clear that the Abacus marketing material and offering documents provided by Goldman to investors contained no mention of Paulson's short position in the CDO nor the significant role it played in the selection of the CDO's reference assets." *Id.* at 571. "Still another troubling omission was Goldman's failure to advise potential Abacus investors that the firm's own economic interests were aligned with those of the Paulson hedge fund." *Id.*
249. Susanne Craig & Ben Protess, *Former Trader Is Found Liable In Fraud Case*, N.Y. TIMES (Aug. 1, 2013, 3:36 PM), *archived at* http://perma.unl.edu/5AJC-8WBL ("A federal jury found the trader, Fabrice Tourre, liable on six counts of civil securities fraud after a three-week trial in Lower Manhattan. . . . The S.E.C.'s case against Mr. Tourre hinged on the contention that he and Goldman sold investors a mortgage security in 2007 without disclosing a crucial conflict of interest: a hedge fund that helped construct the deal, Paulson & Company, also bet that it would fail."); Justin Baer, *Tourre Verdict Could Prolong Goldman's Pain*, WALL ST. J. (Aug. 4, 2013), http://online.wsj.com/news/articles/SB1000 1424127887323420604578647971040860936, *archived at* http://perma.unl.edu/ P986-AFRT ("A federal jury found Mr. Tourre liable on Thursday for six of the government's claims that he misled investors in a complex credit instrument called Abacus 2007-AC1. Among the jury's findings: Mr. Tourre, a former trader who had helped create Abacus, aided and abetted Goldman in violating securities laws.").
250. *See, e.g.*, 29 U.S.C. § 260 (2012) (according to the Fair Labor Standards Act, an employer who violates the federal overtime provisions is liable for liquidated damages equal to one hundred percent of the amount of compensatory damages where the employer's actions were not taken in good faith); 5 U.S.C. § 563(a)(3)(B) (2012) (stating that an agency may engage in a negotiated rulemaking via committee if there is a reasonable likelihood that a committee

law.[251] Accordingly, the CFTC (or federal courts) could, when interpreting Regulation 23.433, draw principles of good faith and fair dealing from other areas of the law as a way to further delineate, *inter alia*, what constitutes violations of the duty of swap entities to communicate fairly with counterparties. Contract law appears to be a strong candidate from which one could borrow principles of good faith and fair dealing. After all, swap agreements and other derivatives are contracts, so contract law would seem like a natural source for good faith principles to better define Regulation 23.433's duty to communicate fairly with counterparties. Indeed, in the External Business Conduct Standards adopting release, the CFTC looked to the *Restatement (Second) of Contracts* in connection with what constitutes an "offer,"[252] which shows that contract law principles are valid sources of law for swap contracts. Further, contract law's implied covenant of good faith and fair dealing has been analyzed by numerous judicial decisions[253] and law review articles[254] from which courts—and even the CFTC—could import principles of good faith and fair dealing to use in interpreting the duty that Regulation 23.433 imposes on swap entities.

According to one scholar, contract law largely has been under-utilized in analyzing issues related to the financial crisis, even though "[a]t the bottom of the financial crisis lie failed contracts[,]" and

could be convened with a balanced representation of persons who will be significantly affected by the rule and who are willing to negotiate in good faith to reach a consensus on it); 2 U.S.C. § 438(e) (2012) (stating that "any person who relies upon any rule or regulation prescribed by the [Federal Election Commission] in accordance with the provisions of this section and who acts in good faith in accordance with such rule or regulation shall not, as a result of such act, be subject to any sanction . . . .").

251. *See, e.g.*, Hoffman v. Red Owl Stores, Inc., 26 Wis. 2d 683 (1963) (contract law); Dickey v. Philadelphia Minit-Man Corp., 377 Pa. 549, 556 (1954) (contract law); Ball v. Wilshire Ins. Co., 221 P.3d 717 (Okla. 2009) (tort law); Universe Life Ins. Co. v. Giles, 950 S.W.2d 48, 50–51 (Tex. 1997) (tort law); Burlington N. & Santa Fe Ry. Co. v. White, 548 U.S. 53, 58 (2006) (employment discrimination).

252. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9741 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.400).

253. *See* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968) (cataloguing and analyzing different contract law cases invoking good faith).

254. *See, e.g.*, Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954); Eric M. Holmes, *A Contextual Study of Commercial Good Faith: Good Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381 (1978); Monique C. Lillard, *Fifty Jurisdictions in Search of a Standard: The Covenant of Good Faith and Fair Dealing in the Employment Context*, 57 MO. L. REV. 1233 (1992). For a more exhaustive list, see Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, 80 ST. JOHN'S L. REV. 559, 560–61 n.4 (2006).

"[f]ailed contracts are the stuff of contract law."[255] Professor George M. Cohen of the University of Virginia School of Law has noted that, even though the financial crisis involved failed contracts, "to date, most discussions of possible responses to the financial crisis ignore contract law."[256] Admittedly, Professor Cohen's comments were in connection with an article focusing on "the contract at the root of the crisis, the residential home mortgage loan[,]"[257] and not swap contracts. But Professor Cohen's general point—that scholars analyzing issues related to the financial crisis largely have overlooked potentially viable contract-law theories to resolve lingering questions—may have merit. Perhaps the CFTC could look to contract law jurisprudence for guidance in determining the fair dealing rule's scope.

The implied covenant of good faith and fair dealing has been called "a fundamental concept of modern contract jurisprudence."[258] Section 205 of the *Restatement (Second) of Contracts* states that "[e]very contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement."[259] The Uniform Commercial Code imposes an obligation of good faith in performance and enforcement on every contract that falls within its ambit,[260] and it defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[261] Further, most U.S. jurisdictions have recognized the implied covenant of good faith and fair dealing in their decisional law.[262]

Some attribute the origin of the implied covenant of good faith and fair dealing to New York state jurisprudence in the early Twentieth Century. For example, in 1903, the New York Court of Appeals stated that "[t]he obligation of good faith and fair dealing towards each other is implied in every contract of this character."[263] And in 1914, the Court of Appeals stated that "the obligation of good faith in carrying

255. George M. Cohen, *The Financial Crisis and the Forgotten Law of Contracts*, 87 TUL. L. REV. 1, 2 (2012).

256. *Id.*

257. *Id.* at 4.

258. Dubroff, *supra* note 254, at 559.

259. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

260. U.C.C. § 1-304 (2003).

261. U.C.C. § 1-201(b)(20) (2003). Every state except Louisiana has adopted the Uniform Commercial Code. Emily M.S. Houh, *The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?*, 2005 UTAH L. REV. 1, 1 (2005) (citing David V. Snyder, *Private Lawmaking*, 64 OHIO ST. L.J. 371, 379 (2003)).

262. Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 369 (1980).

263. New York Central Ironworks Co. v. United States Radiator Co., 174 N.Y. 331, 335 (1903); *see* Dubroff, *supra* note 254, at 569–70 (discussing the *New York Central Ironworks* decision).

out what is written" was "a contractual obligation of universal force[.]"[264] In 1933, the Court of Appeals further stated:[265]

> [I]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists and implied covenant of good faith and fair dealing.

In describing the implied covenant, Section 205 of the *Restatement (Second) of Contracts* states as follows:

> Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of power to specify terms, and interference with or failure to cooperate in the other party's performance.[266]

Therefore, contract law has a robust history of good faith jurisprudence that appears broad enough to handle a variety of factual circumstances.

B. Drawbacks to Using Contract Law Principles of Good Faith

Unfortunately, analysis of contract law's implied covenant of good faith and fair dealing reveals that it is unsuitable for supplying principles on which to base violations of the CFTC's fair dealing rule. First, good faith in contract law frequently is used for "gap filling" in contracts that are silent on a particular issue and not for civil enforcement actions targeting wrongdoing.[267] As such, decisions invoking good faith as a contract gap filler would involve extremely different circumstances than situations involving enforcement actions by a financial regulator civilly prosecuting improper communications by swap entities. Second, the predominate view is that the implied covenant only applies to the *performance* and *enforcement* of contracts, and

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264. Brassil v. Md. Gas Co., 210 N.Y. 235, 241 (1914).
265. Dubroff, *supra* note 254, at 565 (citing Kirk La Shell v. Paul Armstrong Co., 263 N.Y 79 (1933)).
266. RESTATEMENT (SECOND) CONTRACTS § 205, cmt. d (1981).
267. Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 812 (1982) (stating that the implied covenant of good faith "is a kind of 'safety valve' to which judges may turn to fill gaps and qualify or limit rights and duties otherwise arising under rules of law and specific contract language"). One noted legal commentator even suggested that the only role of good faith is to "imply[ ] terms in the agreement." E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 670 (1963).

not their negotiation or other pre-contractual communications,[268] whereas the CFTC's fair dealing rule covers all communications concerning a swap, "including communications made prior to an offer."[269] This issue is critical, because one of the main purposes of the Regulation 23.433 is to police sales communications of swap entities,[270] and such communications include pre-contractual discussions, such as sales pitches, and the negotiation of the terms of swap agreements. Therefore, jurisprudence concerning contract law's implied covenant of good faith and fair dealing likely would be of limited utility for the fair dealing rule, given that contract law's implied covenant does not address pre-contractual sales pitches and related communications, which are of primary importance to Regulation 23.433.

Lastly, the exact contours of the implied covenant of good faith and fair dealing vary by jurisdiction, with a majority of jurisdictions reading the doctrine in a "restrictive fashion,"[271] with some jurisdictions holding that "[t]here is no general implied covenant of good faith" and others stating that "[t]he obligation does not exist under every contract . . . ."[272] Under such circumstances, with jurisdictions differing in their views as to the scope and applicability of the implied covenant and many jurisdictions limiting the breadth of the doctrine, importing principles of good faith and fair dealing from contract law would not provide greater clarity as to the obligations imposed by the CFTC's fair dealing rule. Even more, adopting a narrow and restrictive view of good faith from contract law would run counter to the intention of Congress, which included the fair dealing mandate in CEA Section 4s(h) and thereby explicitly directed the CFTC to require swap entities to improve their behavior when communicating with counterparties.

While the *content* of contract law jurisprudence in connection with the implied covenant of good faith and fair dealing appears to be a poor source of law for the fair dealing rule, perhaps one contract law *conceptual approach* to good faith is worth borrowing for purposes of better defining the scope of Regulation 23.433's prohibition on unfair

268. RESTATEMENT (SECOND) CONTRACTS § 205 cmt. c (1981) ("Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions. Particular forms of bad faith in bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud and duress."); Houh, *supra* note 261, at 3–4 (observing that the implied covenant "fails to reach the most troubling forms of contractual bad faith: those that occur during contract negotiation and formation").

269. Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9741 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.400).

270. *See id.* at 9769–70.

271. Edward J. Imwinkelried, *The Implied Obligation of Good Faith in Contract Law: Is It Time to Write Its Obituary?*, 42 TEX. TECH. L. REV. 1, 9 (2009).

272. *Id.* at 10.

and unbalanced communications. In particular, Emeritus Professor Robert S. Summers of Cornell Law School, developed an "excluder" conceptualization of good faith[273] that could provide greater specificity concerning the kinds of communications that violate Regulation 23.433.

C. The "Excluder" Conceptualization of Good Faith as a Possible Model Framework for the Fair Dealing Rule

Rather than affirmatively say what good faith is, one could alternatively define good faith by developing a list of concrete examples of what it is not. In this manner, the notoriously ambiguous concept of good faith could become more clear through illustrations of its opposite. Such is the approach to good faith taken by Section 205 of the *Restatement (Second) of Contracts*, adopted by the American Law Institute in 1979 and published in final form in 1981.[274] Section 205 of the *Restatement* adopted the "excluder conceptualization" framework for good faith that was first advocated by Professor Summers in a 1968 *Virginia Law Review* article.[275] Professor Summers stated that "good faith is an 'excluder' . . . [in that i]t is a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogeneous forms of bad faith."[276] Professor Summers stated that, "[i]n a particular context the phrase takes on specific meaning, but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out."[277] Put simply, Professor Summers believed that one could most easily understand good faith by reference to concrete examples of bad faith behaviors.[278] In adopting an excluder conceptualization of good faith, "Section 205 [of *Restatement (Second) of Contracts*] is an unusually 'circumstance-bound' requirement, and excludes highly varied forms of bad faith, many of

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273. Summers, *supra* note 253, at 195.

274. Summers, *supra* note 267, at 810–11, 825. "[G]ood faith is conceptualized in section 205 as an excluder—having no general, positive, content of its own—which functions to rule out a wide variety of forms of bad faith." *Id.* at 827.

275. *See id.* at 820; Houh, *supra* note 261, at 2 ("In 1981, the American Law Institute adopted Summers's approach at section 205 of the *Restatement* and in the text of its Official Comments section."). The Article that influenced the *Restatement (Second) of Contracts* is Summers, *supra* note 253, at 195.

276. Summers, *supra* note 253, at 201; *see* Summers, *supra* note 267, at 819.

277. Summers, *supra* note 253, at 201.

278. *See* Summers, *supra* note 267, at 818. Professor Summers stated that his "conceptualization" of good faith as an "excluder" derived from the work of the philosopher J.L. Austin of Oxford University. *Id.* at 818–19. "To paraphrase J.L. Austin, the attempt to capture in a set of normally necessary and sufficient conditions some characteristic or characteristics common to all things that are or could be called 'good faith' is doomed to failure." *Id.* at 828.

which become identifiable only in the context of circumstantial detail of a kind that defies comprehensive formulation in a single rule."[279]

Using an excluder concept of good faith, Professor Summers maintained that one could create a list of specific examples of prohibited bad faith and thereby develop a better understanding of its opposite, good faith.[280] For example, Professor Summers stated that "[t]he beginnings of such a list might look like this:"[281]

Form of Bad Faith Conduct	Meaning of Good Faith
1. Seller concealing a defect in what he is selling	fully disclosing material facts
2. Builder willfully failing to perform in full, though otherwise substantial performing	substantially performing without knowingly deviating from specifications
3. Contractor openly abusing bargaining power to coerce an increase in the contract price	refraining from abusing bargaining power
4. Hiring a broker and then deliberately preventing him from consummating the deal	acting cooperatively
5. Conscious lack of diligence in mitigating the other party's damages	acting diligently
6. Arbitrarily and capriciously exercising a power to terminate a contract	acting with some reason
7. Adopting an overreaching interpretation of contract language	interpreting contract language fairly
8. Harassing the other party for repeated assurances of performance	accepting adequate assurances[282]

Professor Summers' excluder conceptualization of good faith has been criticized. Indeed, the belief that one cannot define good faith except by reference to bad faith, which itself cannot be defined except by way of specific examples, does not exactly remove vagueness or am-

279. *Id.* at 821.
280. Summers, *supra* note 253, at 202 ("Good faith, then, takes on specific and variant meanings by way of contrast with the specific and variant forms of bad faith which judges decide to prohibit.").
281. *Id.* at 202–03.
282. This list is taken verbatim from Summers, *supra* note 253, at 203.

biguity from the concept of good faith.[283] But there is strength in Professor Summers's argument that attempts to find a single, all-purpose meaning of "good faith" (for example, one suggestion was to define good faith as the "absence of intention to harm a legally protected pecuniary interest") generally result in "very little, if any, genuine *definitional* guidance."[284] All too often, attempts to define broad terms such as "good faith" are ambiguous and unhelpful,[285] whereas specific examples of violative conduct at least can delineate the contours of good faith like stakes in the ground marking a parcel of land's boundaries.

D. Applying an Excluder Conceptualization to Regulation 23.433

In any event, even if one were to disagree with the use of an excluder conceptualization of good faith for purposes of contract law, it does not necessarily follow that an excluder conceptualization would be inappropriate for the purposes of providing guidance in connection with Regulation 23.433. Indeed, an excluder conceptualization seems particularly appropriate for an open-ended principle such as the CFTC's fair dealing rule. Based on the External Business Conduct Standards adopting release, NFA guidance and the Senate Report contain examples of unfair and unbalanced communications that would violate Regulation 23.433. Using an excluder conceptualization, the CFTC could create a list of the specific kinds of communications that are unfair and unbalanced in violation of derivatives industry principles of good faith and fair dealing, and that list would serve to illustrate not only what kind of communications violate Regulation 23.433, but also what kind of communications are fair and balanced. In short, one would define fair and balanced communications by their opposite through concrete examples of unfair and unbalanced communications taken from NFA guidance and the Senate Report. However, while an excluder framework likely would provide greater clarity concerning the kinds of communications that the fair dealing rule prohibits, it should not be the only method used to do so. After all, the adopting release states that Regulation 23.433 incorporates concepts of fairness from NFA rules and notices, and those rules and notices have positive, affirmative definitions and meanings, which is an approach that is contrary to an excluder conceptualization. The CFTC should not disregard the years of thought and development that went into the NFA rules and related guidance that affirmatively define industry obligations to behave ethically and communicate fairly,

283. Dubroff, *supra* note 254, at 594.
284. Summers, *supra* note 267, at 829 (citation omitted).
285. For example, the maxim, "Fairness is what justice really is," is unhelpful in defining either fairness or justice.

but an excluder conceptualization could provide an additional framework through which one could organize and present NFA guidance in connection with the CFTC's fair dealing rule.

Accordingly, if Regulation 23.433 has the same scope as the NFA guidance cited by the CFTC in the proposing and adopting releases (i.e., focusing on the NFA customer communications rule and related interpretive notices), and if it also serves to prohibit the improper conduct outlined in the Senate Report, then the fair dealing rule likely prohibits communications that:[286]

(1) State that trading swaps is appropriate for all persons;[287]

(2) Fail to balance the potential opportunities or advantages presented by a swap with statements of corresponding risks (e.g., by discussing potential profits more frequently, or in a larger font size, than discussions of possible risks);[288]

(3) Refer to actual past trading profits without mentioning that past results are not necessarily indicative of future results;[289]

(4) Fail to disclose the costs (i.e., fees and charges) of trading when introducing an account;[290]

(5) Include statements of opinion that are not disclosed as such;[291]

(6) Include statements of opinion that do not have a reasonable basis in fact;[292]

(7) Use hypothetical performance results in a manner that conflicts with NFA or CFTC rules (e.g., without required disclaimers, etc.);[293]

(8) Involve high-pressure sales practices, which, generally speaking, are tactics that pressure prospective customers to make

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286. This list has been compiled without regard to whether a communication is "routine" or contained in "promotional material," as that distinction is not found in the CEA or in CFTC Regulations. Additionally, some of the examples below also likely constitute fraud, which means that they also would violate antifraud provisions in the CEA and CFTC Regulations.

287. *See Interpretive Notice 9003*, *supra* note 109.

288. *See Rule 2-29. Communications with the Public and Promotional Material*, *supra* note 114, at (a)(3); Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9769 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.433).

289. *Rule 2-29. Communications with the Public and Promotional Material*, *supra* note 114, at (a)(3).

290. *Rule 2-4. Just and Equitable Principles of Trade*, *supra* note 116; *Interpretive Notice 9005*, NAT'L FUTURES ASS'N, http://www.nfa.futures.org/nfaManual/NFAManual.aspx#5 (last visited Feb. 23, 2014), *archived at* http://perma.unl.edu/4PV2-XNF9.

291. *Rule 2-29. Communications with the Public and Promotional Material*, *supra* note 114, at (d).

292. *Id.*

293. *Interpretive Notice 9025*, *supra* note 152.

hasty decisions, i.e., to act now and think later by, *inter alia*, barraging customers with repeated telephone calls at unusual times or by berating or bullying customers;[294]

(9) Rely on isolated trades in specific customer accounts (i.e., cherry-picked trades) to claim that other customers have made dramatic profits;[295]

(10) State that tremendous profits would result from projected price movements that are characterized as conservative estimates, when in fact such price movements would be dramatic;[296]

(11) Use price data for a financial product different from the one being marketed;[297]

(12) Imply that customers are likely to make substantial profits by following recommendations that are purported to be based on, *inter alia*, factors such as seasonal data that supposedly shows that certain trades produce dramatic profits year in and year out, or historic price moves that are predicted as being likely to occur again;[298]

(13) Fail to provide a sound basis for evaluating the facts with respect to swaps by, *inter alia*, refusing to provide prospective counterparties with pricing methodology, data scenarios, or specific marks;[299]

(14) Use outdated information to support current claims;[300]

(15) Make claims regarding research or other facilities beyond those which the person making the claims actually possesses or can provide;[301]

(16) State that a report, analysis or other service will be furnished free unless such report, analysis, or service actually will be furnished free and without condition or obligation;[302]

(17) Use projected performance results that do not have a reasonable basis in fact;[303]

(18) Fail to identify all of the material assumptions associated with projected performance results;[304]

294. *Interpretive Notice 9038*, *supra* note 161.
295. *Interpretive Notice 9039*, *supra* note 168.
296. *Id.*
297. *Id.*
298. *Id.*
299. STAFF, SENATE REPORT, *supra* note 8, at 509–10.
300. *Interpretive Notice 9043*, *supra* note 174.
301. *Id.*
302. *Id.*
303. *Id.*
304. *Id.*

(19) Refer to projected performance results without a discussion of the risks to balance the reference to projected profits;[305]
(20) Refer to past performance results without indicating the general market conditions during the period covered;[306]
(21) Market, promote, or sell a swap without disclosing any of the following:
   i. Material adverse incentives or conflicts of interests, such as the receipt of any form of payment in connection with a swap in addition to the amount paid by the counterparty;[307]
   ii. Information concerning the price of the swap, including the methodology used to determine that price;[308]
   iii. One's expectation that the swap in question would perform poorly or fail;[309]
   iv. One's knowledge that the overall market for these kinds of swaps was deteriorating;[310]
   v. The fact that the swap was structured or designed to perform poorly or fail.[311]

The above list is just one example of how an excluder conceptualization could provide greater clarity to Regulation 23.433's prohibitions. Use of an excluder conceptualization would involve creating a list of short examples, with each example describing communications that violate the CFTC's fair dealing rule. Here, the one-sentence examples come from the Senate Report and selected NFA guidance, but one could pull additional examples from, *inter alia*, decisions by the NFA's Business Conduct Committee invoking relevant Compliance Rules or federal court decisions on the CEA's antifraud provisions. Thus, under an excluder conceptualization, one would define communications that are fair and balanced based on principles of good faith and fair dealing by their opposite—unfair and unbalanced communications that violate principles of good faith and fair dealing—as illustrated by concrete examples.

VI. CONCLUSION

Congress directed the CFTC to promulgate a rule to ensure that swap entities communicated in a fair and balanced manner based on

305. *Id.*
306. *Id.*
307. *See* STAFF, SENATE REPORT, *supra* note 8, at 391, 525–26, 541; Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9734, 9769–70 (Feb. 17, 2012) (to be codified at 17 C.F.R. § 23.433).
308. *See* STAFF, SENATE REPORT, *supra* note 8, at 509–10.
309. *See id.* at 384–85, 396, 517–18, 564–67.
310. *See id.* at 319, 330–31.
311. *See id.* at 396, 561–62.

principles of good faith and fair dealing. The CFTC, in adopting Regulation 23.433, stated that its fair dealing rule would incorporate futures industry principles of good faith and fair dealing as embodied in NFA guidance. The CFTC further stated that its fair dealing rule would serve to prohibit the kind of conduct that, as documented in the Senate Report, swap dealers perpetrated in the years leading up to the financial crisis. But despite those efforts to clarify what would be covered by the fair dealing rule, many ambiguities remained.

In an attempt to provide greater clarity to the CFTC's fair dealing rule, this Article analyzed NFA guidance, the Senate Report, and, in seeking alternative sources of good faith principles, contract law doctrines related to good faith. Analysis of NFA guidance revealed that industry principles of good faith and fair dealing prohibit, among other things, high-pressure sales practices and communications that do not balance mention of potential benefits of a trading strategy with an accompanying discussion of the risks. Further, in a departure from the CEA and CFTC Regulations, NFA Compliance Rule 2-29(b) prohibits negligent misrepresentations contained in promotional material, which is defined broadly to include many kinds of communications, from emails to advertisements. Compliance Rule 2-29(b) also appears to place the burden on the defendant to show the accuracy or reasonableness of statements that, among other things, purport to reference prior or projected trading performance results. Additionally, an examination of the improper conduct by swap dealers and their salespeople as described in the Senate Report reveals that the CFTC envisions Regulation 23.433 as prescribing failures to disclose material incentives and conflicts of interest on the part of swap dealers, as well as failures to disclose information relating to the source of underlying swap assets and the purposes for which swaps were created and structured.

Undoubtedly, with time, the CFTC, the NFA, and the federal courts are likely, either through decisions on cases or via additional guidance, to provide more information concerning the principles of good faith and fair dealing for swap entities. In the meantime, pursuant to an excluder conceptualization of good faith, fact patterns describing the specific kinds of abusive and unfair communications identified in NFA guidance and in the Senate Report can serve as guideposts indicating what swap entity salespeople should *not* do when interacting with counterparties, lest they risk running afoul of the CFTC's fair dealing rule. In this manner, Regulation 23.433 can serve an important regulatory function by complimenting other business conduct standards and existing prohibitions on improper or unethical behavior by swap entities.