Final Rules Regarding Disqualified Actors in the Security-Based Swaps Market

Commissioner Robert J. Jackson Jr.

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Thank you, Chairman Clayton, and thank you and happy holidays to the terrific Staff in the Division of Trading and Markets. I'm especially grateful to Director Brett Redfearn, Natasha Greiner, Devin Ryan, and Ed Schellhorn from Trading and Markets; Claire O'Sullivan and Diana Knyazeva from the Division of Economic and Risk Analysis; and Lori Price, Robert Tepley, and Donna Chambers from the Office of General Counsel, each of whom provided especially thoughtful briefings throughout this process.

The Commission today is finalizing changes to our Rules of Practice governing whether, and how, market participants that have been statutorily disqualified[1] can continue trading in our security-based swap markets.[2] Implementing Dodd-Frank's protections in these markets is a critical and important step, and I congratulate my colleagues on moving this process forward.

But today's adopting release relies on other regulators and market participants—rather than the Staff of this Commission—to impose discipline on bad actors in the security-based swap markets.[3] Because I am unconvinced that reliance on these mechanisms will provide enough deterrence to protect investors in these especially opaque, concentrated, and critical markets, I respectfully dissent.

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Today's release addresses a critical question: how can we best deter market participants from engaging in misconduct in our security-based swap markets? We have a wide range of tools for doing so,[4] but none nearly as powerful as disqualification. The reason, of course, is that nothing is as valuable to security-based swap traders as access to the deepest and most liquid capital markets in the world. So when market participants consider engaging in wrongdoing, the prospect that they will be barred from the marketplace if they're caught looms large in their calculus regarding the costs of harming investors.[5]

That's why Congress empowered this Commission to oversee whether, and how, bad actors could reenter these markets. As in other areas, the prospect of having to prove to our thoughtful, exacting Staff that past wrongdoing does not pose future risk to investors provides a powerful ex ante deterrent for wayward traders.[6]

Today's release sets forth a process for individuals who have been disqualified to seek waivers from the Commission. But the rule also partly cedes that oversight to others by allowing disqualified entities to stay in our markets when another regulatory body has previously given its approval. Our Staff's perspective on these questions is unique and important. I cannot see why independent review by this agency should not be required before bad actors can pursue the privilege of continuing to trade with American investors.

More generally, I do not understand the economic case for smoothing bad actors' path to readmission. There is no free lunch in financial markets. If we fail to deter bad actors, investors will have to pay to protect themselves. I

cannot see why we should ask investors to bear those costs rather than provide the more meaningful deterrence that Congress envisioned in Dodd-Frank.

Moreover, if there's a market in which we should rely on investors, rather than the Commission, to deter bad actors, this isn't it. In order to protect themselves, investors need information and competition. Information allows investors to identify potential wrongdoers, imposing high reputational costs that serve as a deterrent.[7] And competition allows investors to impose the ultimate penalty when market participants misbehave: taking their business elsewhere. But the security-based swaps market offers investors little of either. As to information, this market is famously opaque, making it especially costly for investors to find out whether, and how, a bad actor might harm them in the future. And as to competition, this market is among the most concentrated of those we oversee. As the release notes, in 2017 the top five dealer accounts engaged in over 55% of transactions in this market—leaving aggrieved investors few ways to vote with their feet.[8] So this market is especially ill-suited for reliance on other regulators and investors when it comes to deterring bad actors. Accordingly, I cannot support the choices reflected in today's final rule.

I am deeply grateful for the Staff's hard work on this rule. Although I cannot support today's recommendation, meeting our statutory mandate under the Dodd-Frank Act should be a top priority for the Staff and the Commission—and I very much look forward to future recommendations that will bring the agency into compliance with that landmark law.

[1] 15 U.S.C. § 78(o)-10(b)(6); *see also id.* § 78(c)(a)(39) (A)-(F) (disqualifying events include, inter alia, certain felony criminal convictions, bars ordered by this Commission, the Commodity Futures Trading Commission, and certain other authorities, and temporary and permanent injunctions issued by a court).

[2] *See* Securities and Exchange Commission, Adopting Release, *Applications by Security-Based Swap Dealers or Major Security-Based Swap Participants for Statutorily Disqualified Associated Persons to Effect or be Involved in Effecting Security-Based Swaps*, Release No. 34-___, 10, at 8 (Dec. 19, 2018) [hereinafter Adopting Release] ("Rule of Practice 194 provides a process by which an SBS Entity may apply to the Commission for an order permitting an associated person to effect or be involved in effecting security-based swaps . . . who is subject to a statutory disqualification and is thereby otherwise prohibited from effecting or being involved in effecting security-based swaps on behalf of an SBS Entity under Exchange Act Section 15F(b)(6).").

[3] The final rule allows a statutorily disqualified market participant to effect or be involved in effecting security-based swaps by filing notice with the Commission in cases where a registered futures association, like the National Futures Association, has granted relief from a statutory disqualification for that person. Id. at 40.

[4] Our Enforcement Division can, when necessary, provide additional deterrence through enforcement actions. But that work requires significant resources—while a statutory disqualification serves a powerful deterrent purpose with limited additional commitment of Commission resources to root out future misconduct.

[5] Firms engaging in misconduct identified by regulators face significant reputational penalties—in addition to sanctions imposed by criminal or civil authorities—especially when customers are harmed. See, e.g., Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J. L. & Econ. 489 (1999); *see also* Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J. L. & Econ. 757 (1993). It has long been understood that sanctions of this kind play a significant role in ex ante deterrence; for the seminal work on that subject, see Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968).

[6] For example, Rule of Practice 102(e), which was first adopted in 1935, authorizes the Commission to deny accountants, attorneys, and other professionals "temporarily or permanently, the privilege of appearing or practicing before [the Commission] in any way." 17 C.F.R. § 201.102(e)(1). Similarly, the Commission routinely, and quite properly, uses its broad authority under our organic statutes to bar individuals from associating with registered broker-dealers or investment advisers. *See, e.g.*, 15 U.S.C. § 80b-3 (providing statutory authority for certain bars from association with investment advisers).

[7] For an example from the broker-dealer context—in which information on broker misconduct that the Financial Industry Regulatory Association makes available to the public plays a meaningful role in deterring future theft—see Colleen Honigsberg & Matthew Jacob, *Deleting Misconduct: The Expungement of BrokerCheck Records* (working paper) (November 2018); Hammad Qureshi and Jonathan S. Sokobin, *Do Investors Have Valuable Information About Brokers?* (working paper) (Aug. 2015); see also Jean Eaglesham & Coulter Jones, *FINRA Arbitrators Let Thousands of Brokers Purge Infraction Records*, Wall St. J. (Nov. 17, 2018) (documenting potential costs of permitting previous records of alleged wrongdoing to be removed from public databases).

[8] *See* Adopting Release, supra note 2, at 76 (drawing this conclusion on the basis of Staff analysis of 2017 single-name credit default swaps in the trade information warehouse).