

DERIVATIVES LAW SYLLABUS, FALL 2018

Gary E. Kalbaugh
Classroom: []
6:10 PM-8:00 PM
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Purpose of the Course: The purpose of this course is to teach the current law and practice regarding the documentation, negotiation, regulation and enforcement of derivatives and other related financial products. The futures market is one of the most varied in the world. Commodities as diverse as live hogs, gold, coffee, and securities indexes all are available and usually from the same trading market. The sometimes controversial swaps market is one of the largest financial markets in the world. Yet, it is only recently regulated. The subject of this course are these markets, their transactions, and participants.

Specifically covered are: (1) the Commodity Exchange Act's regulatory regime for commodity futures, exchange-traded commodity options and foreign exchange; (2) the roles of the Commodity Futures Trading Commission, the National Futures Association, and the Securities and Exchange Commission; (3) the swaps regulatory regime imposed by the Dodd-Frank Act; (4) the registration categories of markets, such as designated contract markets, derivatives clearing organizations, and swaps execution facilities, and market participants, such as futures commission merchants, introducing brokers, swap dealers and major swap participants; (5) hedge funds and commodity investment vehicles; (6) industry standard ISDA Master Agreements; (7) inter-jurisdictional differences in regulation and the extraterritorial application of U.S. regulation; and (8) enforceability issues in bankruptcy. By the end of the course, you should be familiar with the regulatory regime applying to derivatives and the basics of transactional documentation.

Course Materials: Kalbaugh, *Derivatives Law and Regulation*, 2d ed. (Carolina Academic Press 2018), ISBN: 978-1-5310-0415-6. Other materials will be made available via TWEN or class handouts.

Classes: This class (CRN: 94743) is scheduled to meet for two credit hours per week, on Mondays from 6:10-8 PM in [].

Attendance and Preparation: Sometimes you cannot avoid missing a class. If you know in advance that you will be missing a class for a compelling reason, or if you have missed a class due to illness or emergency, please send me an e-mail, briefly explaining the situation. Otherwise, students are expected to attend classes regularly and to prepare for classes conscientiously. If you miss class frequently or are unprepared several times, your grade may be lowered.

Lateness: It is better to come to class late than not at all. If you know you'll be late, please let me know. Otherwise, please do not abuse this privilege.

“TWEN” (The West Education Network): A course page for this class is set-up on TWEN. TWEN gives me a quick way to reach all of you with any announcements, Syllabus changes, handout materials and interesting links. It also gives me a way to extend class discussion beyond the classroom hours.

Final Grade for the Course: The course is primarily lecture-based, with a strong emphasis on class participation. The final grade will be derived from the results of a final exam with the potential for a one-level grade “bump up” for exemplary class participation.

Final Exam: The final exam will consist of multiple choice, true/false, and short answer questions.

Laptop Policy: Laptops may be used during class for taking notes.

Communications: The best way to communicate with me is by e-mail at the above address. I will get back to you within 24 hours. I also am usually available after class. Also, while I do not maintain regular office hours, if you need to speak with me in person, we can set up an appointment either before or after class or for a telephone call.

Summary of Course:

Week 1: *Introduction to Derivatives*

- What are derivatives and why do we use them?
- The basic building blocks: options, forwards, and swaps.
- The economic fundamentals of an interest rate swap and an illustration of “hedging.”
- Different categories of futures and swaps.
- Who uses derivatives and why?
- The legal definition of “swap” in contrast to financial definition.

Required Reading: Deriv. Law, 3-36.

Recommended Reading: “Online Learning Guide to Trading Futures” mini-course (visit the website of the National Futures Association and click through the tab for Investor Information until you find the “Online Learning Guide to Trading Futures” and the related mini-course).

Week 2: *The Origins of Derivatives Regulation*

- The history of derivatives regulation in the United States.
- Origins of the Commodity Exchange Act and Commodity Futures Trading Commission.
- The roller-coaster ride of regulation and deregulation.
- The role of the Futures Industry Association and International Swaps and Derivatives Association.

Required Reading: Deriv. Law, 37-84.

Recommended Reading: Podcast, *The Great Onion Corner and the Futures Markets*, <http://www.npr.org/2015/10/22/450769853/the-great-onion-corner-and-the-futures-market>.

Week 3: *The Commodity Exchange Act and Commodity Futures Trading Commission*

- The Commodity Futures Trading Commission and its structure; role of staff and role of the Commission.
- CFTC's jurisdiction and jurisdictional overlap with regulators, including the Securities and Exchange Commission, Department of the Treasury, Federal Energy Regulatory Commission, and the states.
- The Great Divide: Exchange-traded and off-exchange derivatives.

Required Reading: Deriv. Law, 85-112.

Recommended Reading: None.

Week 4: *Futures Exchanges*

- What is a board of trade?
- Designation as a "contract market."
- Prohibition on off-exchange futures and the oligopoly of exchanges.
- Regulatory "core principles" as means of oversight.
- Derivatives clearing organizations and their roles with respect to futures exchanges.
- Claims against exchanges.
- Foreign futures exchanges and access to U.S. customers.

Required Reading: Deriv. Law, 117-151.

Recommended Reading: None.

Week 5: *Futures Market Intermediaries*

- Futures commission merchants and their market role.
- Regulation of futures commission merchants.
- Customer margin and funds segregation; MF Global and Peregrine failures as case studies.
- Introducing brokers and floor Brokers.
- Role of the National Futures Association.

Required Reading: Deriv. Law, 155-201.

Recommended Reading: None.

Week 6: *Commodity Investment Vehicles*

- What constitutes a hedge fund? How is one established?
- The relation of commodity pools to hedge funds and application of securities law.
- Relevance of commodity pools.
- Commodity pool operators and their regulation; absence of securities law analogue.
- Commodity trading advisors and First Amendment issues.
- Private rights of action against unregistered commodity trading advisors.
- Private fund exemptions and regulation of private investment vehicles.

Required Reading: Deriv. Law, 203-257.

Recommended Reading: None.

Week 7: *Introduction to Swaps Regulation*

- Why regulate swaps?
- Impetus for regulation: Financial Crisis, subprime mortgages, CDOs, and credit default swaps.
- The prohibition on banks entering into asset-backed swaps.
- The Volcker Rule's proprietary trading ban.
- Eligible contract participants and the retail swap prohibition; shifting public policy justifications underlying eligible contract participant requirements.

Required Reading: Deriv. Law, 259-288.

Recommended Reading: None.

Week 8: *Organized Swaps Markets*

- Mandatory clearing and derivatives clearing organizations.
- Clearing exemptions; role of “financial entities.”
- Public policy implications of mandatory swaps clearing.
- Mandatory on-facility trading and swap execution facilities.
- Comparison of regulatory treatment of futures and swaps.
- Reporting requirements and swap data repositories.

Required Reading: Deriv. Law, 293-326.

Recommended Reading: None.

Week 9: *Swap Entity Registrants*

- Dodd-Frank Act’s impact on existing CFTC registrants.
- The National Futures Association’s self-regulatory organization role.
- Swap dealers and *de minimis* exception to registration.
- Major swap participants.
- Entity-level requirements: capital, chief compliance officer, risk management, recordkeeping, and supervision.

Required Reading: Deriv. Law, 327-353.

Recommended Reading: Peruse the Financial Crisis Inquiry Commission Report.

Week 10: *Uncleared Swaps and Their Negotiation*

- External business conduct requirements: verification of eligible contract participant status, disclosure and communication requirements, recommendations and suitability.
- “Special entities” and additional requirements.
- Initial and variation margin.
- Reporting requirements.
- Portfolio reconciliation and compression.

Required Reading: Sample ISDA Master Agreement, Schedule, and Credit Support Annex; Deriv. Law, 355-379.

Recommended Reading: None.

Week 11: *Negotiating Derivatives Agreements*

- The role and history of the International Swaps and Derivatives Association (“ISDA”).
- The way derivatives are documented and negotiated: The ISDA Master Agreement, Schedule, Confirmation, Credit Support Annex, Paragraph 13, and Definitions.
- Payment netting and close-out netting with economic examples.
- Negotiating derivatives agreements.
- Review of commonly negotiated clauses in ISDA Schedule and Credit Support Annex.

Required Reading: Sample ISDA Master Agreement, Schedule, and Credit Support Annex; Deriv. Law, 380-397.

Recommended Reading: None.

Week 12: *Derivatives in Bankruptcy/The Lehman Brothers Experience*

- The derivatives “safe harbors” and the Bankruptcy Code’s automatic stay, prohibition on *ipso facto* clauses, and payment clawbacks.
- Set-off rights and mutuality.
- Bankruptcy for futures and cleared swaps.
- “Futures” model v. “LSOC” model.
- *In re Griffin Trading Company* and “customer property.”
- Cross-border bankruptcies.

Required Reading: Deriv. Law, 403-453.

Recommended Reading: None.

Week 13: *Public and Private Enforcement Actions*

- Civil and criminal fraud; common Department of Justice practices.
- *Kokesh* and the strict application of statute of limitations.
- Market manipulation generally.
- Specific market manipulation abuses: wash sales, fictitious trades, order bucketing, “banging” or “slamming” the close, spoofing, and position limits and cornering.
- Private rights of action generally.
- The LIBOR scandal.
- Claims against CFTC-regulated self-regulatory organizations.
- Reparations proceedings and arbitration.

Required Reading: Deriv. Law, 485-575.

Recommended Reading: None.

Week 14: *Virtual Currency, Blockchain Technology, and Wrap-up Discussion.*

Required Reading: Deriv. Law, 479-483.

Recommended Reading: None.