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FACILITATING CROSS-MARGINING: TREASURY MARKET TRADES AND INTEREST RATE FUTURES

Cross-margining of U.S. Treasury positions and interest rate futures can improve the efficiency and resilience of the U.S. Treasury market by tying margin requirements more closely to the risk of a given portfolio. However, only the largest and most sophisticated market participants have historically been able to cross-margin these positions. The principal reason for this limitation is that U.S. Treasury positions and interest rate futures are cleared at different central counterparties and subject to different regulatory regimes. Although these factors certainly present complications, the authors argue that there are well-established mechanisms that can allow customers to benefit from cross-margining without losing critical customer protections.

By Brandon M. Hammer and Kathryn E. Witchger *

I. INTRODUCTION

Market participants, regulators, and scholars have recently sought to identify mechanisms that will increase the liquidity, resilience, and stability of the U.S. Treasury market.[1] Although these authors have differed on a number of issues, one area of clear agreement is that cross-margining of U.S. Treasury positions and interest rate futures would increase liquidity, improve risk-management, and reduce the likelihood of market disruption in the U.S. Treasury market. For example, the Group of Thirty recently observed that "[w]ider use of cross-margining would reduce the risk that increases in initial margin requirements on the futures leg of cash-futures basis trades result in forced sales of Treasury securities, which may have contributed to selling pressures in the Treasury market in March 2020."[2]

[1] Group of Thirty Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience*, GROUP OF THIRTY (July 2021), https://group30.org/publications/detail/4950 [hereinafter *Steps Toward Increased Resilience*]; FIA Principal Traders Group, *Clearing a Path to a More Resilient Treasury Market*, FIA (July 2021), https://www.fia.org/sites/default/files/2021-07/FIA-PTG_Paper_Resilient%20Treasury%20Market_FINAL.pdf; The Depository Trust and Clearing Corporation, *Making the U.S. Treasury Market Safer for All Participants: How FICC's Open Access Model Promotes Central Clearing*, DTCC (Oct. 2021) https://www.dtcc.com/-/media/Files/Downloads/WhitePapers/Making-the-Treasury-Market-Safer-for-all-Participants.pdf;

footnote continued from previous column…

U.S. Department of the Treasury et al., *Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report*, TREASURY.GOV (Nov. 8, 2021), https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf [hereinafter *Staff Report*].

[2] *Steps Toward Increased Resilience* at 14.

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Likewise, an interagency working group of the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the U.S. Securities and Exchange Commission (the “SEC”), and the U.S. Commodity Futures Trading Commission (the “CFTC”) recognized that “[c]ross-margining between the cash and futures markets can . . . provide balance sheet savings and have the effect of netting down some exposures.”[3]

“Cross-margining,” sometimes also referred to as “portfolio margining” or “cross-product portfolio margining,” generally refers to the process of calculating the margin (*i.e.*, collateral) requirements for a portfolio of positions by reference not to the risk each position presents on an individual basis, but to the risk of the portfolio as a whole. Accordingly, cross-margining allows recognition of risk-offsets that may exist between different positions, such as an agreement to sell a U.S. Treasury security and an interest rate future that hedges the interest rate embedded in the U.S. Treasury security.

Cross-margining is relatively simple when the positions at issue are cleared by the same central counterparty (“CCP”) and subject to the same regulatory regime. However, various regulatory and bankruptcy complications arise when parties seek to cross-margin products that are cleared by different CCPs and subject to different regulatory regimes. To date, market participants and regulators have taken some steps to resolve these impediments. For example, the Fixed Income Clearing Corporation (“FICC”), which clears and settles repurchase agreements on U.S. Treasury securities and purchases and sales of U.S. Treasury securities, has a cross-margining arrangement with the Chicago Mercantile Exchange (“CME”), which clears and settles a variety of interest rate futures. This arrangement allows FICC and CME to calculate margin requirements for certain of their clearing members’ proprietary positions in a way that recognizes the risk offsets between those positions. However, due to regulatory impediments, FICC/CME clearing members have generally not been able to extend similar cross-margining benefits to the positions that they carry on behalf customers. As a result, customer margin requirements may not be as closely tied to the risk of their positions as would be optimal, with deleterious effects for the U.S. Treasury market as a whole.

Historically, the reason for these regulatory impediments has been to protect customers in the event their clearing member becomes bankrupt. Were cross-margining permissible, the thinking has been, customers would be less likely to recover the assets they entrust to their clearing members. However, as we discuss in this article, U.S. bankruptcy laws can accommodate customer cross-margining of FICC-cleared U.S. Treasury positions and CME-cleared interest rate futures while preserving customer protection. Thus, with appropriate regulatory relief, clearing members could carry eligible securities and futures positions in a single SEC- or CFTC-regulated account, and FICC and CME could use their existing processes and agreements to calculate margin requirements. Such an arrangement would allow clearing members to calculate margin requirements that more accurately reflect the risk of their customers’ portfolios without frustrating the ability of customers to recover their property in the event of their clearing member’s bankruptcy.

II. CURRENT CROSS-MARGINING ARRANGEMENTS AND REGULATORY BIFURCATION

If a dealer faces a customer under a portfolio of bilateral, unregulated transactions, it can generally calculate the margin requirements for the customer on the basis of the risk profile of the portfolio as a whole. If the portfolio contains positions that achieve risk offsets (*e.g.*, a contract to purchase an asset coupled with a derivative to hedge one of the risks of the asset), the dealer can calculate a margin requirement that will be lower than if it had assessed the margin for each position independently. This is because the dealer knows that if one position increases in value, there should be a corresponding decrease in the value of the other position. As a result, the net amount owed by the customer to the dealer (and thus the dealer’s credit exposure to the customer) should be less than would be the case for each position standing alone.

[3] *Staff Report* at 30.

The same is true for a CCP and a member. If the member has multiple offsetting positions that it carries with a single CCP, such CCP can reduce the margin requirement for the member. Likewise, if the member is carrying those positions for a customer, it can extend the same reduction in margin to such customer.

Reduced margin requirements serve an important function in increasing market liquidity and incentivizing risk reduction through hedging. If a market participant can reduce its costs of maintaining positions by entering into a hedging position, it will be more inclined to do so. Without such margin reductions, there is a firm disincentive to hedge, since such positions will attract additional margin requirements.

Unfortunately, the bifurcated U.S. regulatory environment imposes a number of impediments to portfolio margining across CFTC- and SEC-regulated products. In order to understand these impediments as applied to cross-margining of U.S. Treasury positions and interest rate futures, it is necessary as an initial matter to identify the key market participants and regulatory regimes.

As noted above, FICC is the principal CCP for transactions on U.S. Treasury securities, and CME is one of the largest CCPs in the United States for interest rate futures. Each of these CCPs clears and settles positions for its members.

Although FICC and CME have similar structures, they and their members are subject to entirely separate regulatory regimes. FICC is registered with the SEC as a clearing agency and its clearing members are typically registered with the SEC as broker-dealers or chartered as banks. CME is registered with the CFTC as a derivatives clearing organization ("DCO") and its clearing members are registered with the CFTC as futures commission merchants ("FCMs").

The impediments to cross-margining FICC- and CME-cleared positions can arise at two levels: First, there is the CCP level. Unlike our example above, FICC and CME are different institutions and do not automatically benefit from increases in value of the positions carried at the other CCP. If an interest rate future increases in value to a member, CME will receive the benefit of the reduced credit risk exposure to the member, while FICC will suffer from increased credit risk arising from a reduction in value to the member of the U.S. Treasury position. Furthermore, each CCP is separately regulated and must set margin requirements and carry positions in accordance with its regulatory regime.

Second, there is the clearing member level. Given the costs and infrastructure required to be a member of a CCP, full-purpose clearing members of FICC and CME are generally limited to large financial institutions. These institutions will typically clear both their own proprietary positions and positions carried for customers. Customers may be limited-purpose members or participants in the CCP or entirely unknown to the CCP.

In order for a clearing member to carry positions for customers at both the FICC and CME, the clearing member must be both an FCM and a bank or broker-dealer. It is generally not feasible for banks to register as FCMs given the regulatory requirements, including the capital requirements, associated with registration. Broker-dealers, however, can and often do dually register as broker-dealers and FCMs. Nonetheless, the CFTC and SEC prescribe different segregation requirements for the positions they regulate even when the positions are carried by the same entity. These segregation regimes generally preclude a broker-dealer FCM ("BD-FCM") from carrying CFTC-regulated positions in an SEC-regulated account, and vice versa, and limit the ability of a BD-FCM to grant liens to third parties on positions carried in the account.

The reason for these bifurcated segregation regimes is to ensure that customers will be protected in the event of the BD-FCM's insolvency. Although organized as a single institution, a BD-FCM that becomes insolvent is subject to separate insolvency regimes for its SEC-regulated and CFTC-regulated estates. These regimes are designed to ensure that customers can recover their margin and positions fully without exposure to the BD-FCM's other activities.

To solve the impediments to cross-margining, one must consider both of these levels. We discuss each level in turn.

A. Cross-Margining at the CCP Level

As noted above, one of the key impediments to cross-margining at the CCP level is the fact that FICC and CME are separate entities and thus do not automatically receive the benefit of the risk-offsets of a member's entire portfolio. If a member clears a contract to purchase a U.S. Treasury security at FICC and hedges its exposure to the interest rate risk on the U.S. Treasury security through an interest rate future cleared at CME, the member's overall market risk will be lower. For example, if interest rates increase, the value of the position at FICC will decline, but the interest rate future should increase in value. However, in this example, FICC does not automatically receive the benefit of the change in the interest rate future. Rather, any gains resulting from that change in value go first to CME and then will be shared by all of the member's creditors.

In the absence of a direct benefit, FICC cannot reduce the margin requirements for the member. However, this impediment is relatively simple to solve. FICC and CME can enter into limited cross-guarantees under which they effectively agree to provide the other with the benefits of the risk-offset. In the example above, this cross-guarantee would require CME to make a payment to FICC equal to the gains CME received as a result of the increase in the value of the interest rate future. CME is then able to offset its reimbursement claim against the member under the cross-guarantee against CME's obligations to pay amounts owing to the member under the interest rate future. Thus, so long as it is enforceable the guarantee effectively replicates the economics that would exist were FICC and CME a single CCP.

With regard to enforceability, this type of cross-guarantee arrangement enjoys special protections under federal law. Specifically, both the U.S. Bankruptcy Code and the Federal Deposit Insurance Corporation Improvement Act specifically protect from avoidance and stay the calculation of a net amount under a guarantee that is related to a cleared securities or commodities transaction.[4] Indeed, considering the effectiveness of this arrangement, a cross-guarantee is the precise mechanism that FICC and CME generally use to cross-margin direct members today.[5]

The other impediment at the CCP level are the regulatory requirements to which the FICC and CME are subject. Both CCPs must generally obtain regulatory approval before engaging in a cross-margining arrangement (or self-certify that the arrangement is permissible under applicable law).[6] To date, the SEC and CFTC have permitted cross-margining of members' proprietary positions.[7] However, before the commissions allow further cross-margining, they will likely need to be confident that the arrangement will likewise be feasible at the clearing member level.

B. Cross-Margining at the Clearing Member Level

As noted above, individual firms can dually register as BD-FCMs and thereby avoid the issue described above of not receiving the benefits of risk-offsets. However, even though organized as a single entity, a BD-FCM is subject to two different segregation regimes. A BD-FCM is required to segregate securities positions, including U.S. Treasury positions, carried for customers in accordance with SEC Rule 15c3-3. Meanwhile, CFTC-regulated positions, such as interest rate futures, must be segregated in accordance with CFTC Rules 1.20 through 1.30. Importantly, these rules generally prohibit a BD-FCM from carrying positions subject to one segregation rule in another account or granting liens on those positions to third parties. These limitations effectively prohibit the BD-FCM from engaging in cross-margining.

Although one can advocate for modifications to the SEC's and CFTC's segregation rules, any such advocacy must take account of the purpose of the rules. Both the sets of rules are designed to work hand-in-hand with the insolvency regimes to which a BD-FCM may be subject. As a dual registrant, a BD-FCM would effectively be subject to two different insolvency regimes. In an insolvency, its customer security positions would be distributed in accordance with the Securities Investor Protection Act of 1970 ("SIPA"),[8] while its futures positions would be subject to subchapter IV of Chapter 7 of the U.S. Bankruptcy Code and the CFTC's Part 190

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[4] 11 U.S.C. §§ 362(b)(6), 546, 555 and 556; 12 U.S.C. § 4403(f) ("The provisions of any security agreement or arrangement or other credit enhancement related to one or more netting contracts between any two financial institutions shall be enforceable in accordance with their terms . . . , and shall not be stayed, avoided, or otherwise limited by any State or Federal law . . . .").

[5] Fixed Income Clearing Corporation and Chicago Mercantile Exchange Inc., *Cross-Margining Agreement*, DTCC (March 11, 2016) https://www.dtcc.com/~/media/Files/Downloads/legal/rules/ficc_cme_crossmargin_agreement.pdf.

[6] 15 U.S.C. § 78s; 17 CFR § 40.06.

[7] *DTCC and CME Go Live Friday With Cross-Margining Service*, GLOBAL CUSTODIAN (April 9, 2002) https://www.globalcustodian.com/dtcc-and-cme-go-live-friday-with-cross-margining-service/. Self-Regul. Organizations; Gov't Sec. Clearing Corporation; Ord. Approving A Proposed Rule Change Relating to Establishment of A Cross-Margining Agreement with the Chicago Mercantile Exch. & A Clarification of the Gov't Sec. Clearing Corp.'s Cross-Margining Rules, Release No. 44301 (May 11, 2001); Letter from Terrence A. Duffy, Chairman, and James J. McNulty, President/CEO, Chicago Mercantile Exchange to Jean A. Web, Sec'y, CFTC, *Statement before the Commission's Roundtable on Derivatives Clearing Organizations*, (Aug. 1, 2002) https://www.cftc.gov/sites/default/files/files/opa/press02/opamcnulty_020801.pdf.

[8] 15 U.S.C. §§ 78aaa et seq.

regulations thereunder.[9] Below, we discuss each of the regulatory regimes of the SEC and CFTC as well as their related insolvency regimes.

1. Segregation and Insolvency Under SIPA

SEC Rule 15c3-3 generally requires a broker-dealer to segregate the cash and securities posted to the broker-dealer by a customer in relation to the customer's securities positions, less the obligations of the customer to the broker-dealers in relation to securities.[10] In order for a position to be "segregated," it generally cannot be subject to liens of third parties (*e.g.*, the CME) and must be held at specified locations (which do not include DCOs). However, customer positions are not subject to individual segregation. Rather, a broker uses omnibus segregation whereby it commingles the positions of multiple customers together.

SEC Rule 15c3-3 is designed to work in tandem with SIPA. Enacted in 1970, SIPA protects customers of a broker-dealer by creating a special customer estate to which the broker-dealer's customers have priority in its insolvency. More specifically, SIPA provides that "customers" of a failed broker-dealer have priority claims to the broker-dealer's "customer property" to the extent of the customers' "net equity" claims.[11] SIPA generally defines "customer" as any person who:

> has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral, security, or for purposes of effecting transfer.[12]

Customer property, in turn, is generally defined as "cash and securities . . . at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer." Lastly, net equity generally means (1) the liquidation value of all of the customer's cash and securities positions (as of the SIPA filing date), minus (2) any indebtedness of the customer to the failed BD, plus (3) certain payments by the customer of such indebtedness.[13]

SEC Rule 15c3-3 is aimed at ensuring that the "customer property" available in a broker-dealer insolvency is sufficient to satisfy all customer net equity claims. There could be insufficient property available to satisfy customer claims to the extent positions are de-segregated (*e.g.*, by being pledged to the CME to secure a customer's futures) or held in other locations. Even with these protections, however, customers could incur losses on account of "fellow customer risk," *i.e.*, the risk that both the broker-dealer and another customer default. In such a situation, there may not be sufficient customer property available to satisfy all customer claims.

2. Segregation and Insolvency Under Part 190

Like SEC Rule 15c3-3, the CFTC's regulations require an FCM to segregate customer positions and associated margin from the positions and associated margin of the FCM's proprietary trades.[14] Furthermore, as with SEC Rule 15c3-3, the CFTC requires an FCM to keep customer property in specified locations (including DCOs, but excluding clearing agencies) and prohibits an FCM from granting a lien on the customer property in favor of third parties, such as a clearing agency. Moreover, as with SEC Rule 15c3-3, the CFTC provides for omnibus segregation, at least in the context of futures.

The CFTC's segregation rules are designed to work in tandem with the rules that apply in an FCM's insolvency. These rules, which are applicable in a SIPA proceeding of a BD-FCM,[15] function similarly to SIPA, in that they create a customer estate to which customers have priority. Specifically, these rules provide that "[p]ublic customers of a debtor futures commission merchant are entitled to a priority in the distribution of cash, securities, or other customer property over non-public customers, and both have priority over all other claimants."[16]

"Customer" is defined as including:

> (i) [any] entity for or with whom [the] futures commission merchant deals and that holds a claim against such futures commission

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[9] 17 C.F.R. pt. 190.

[10] 17 C.F.R. § 240.15c3-3.

[11] 15 U.S.C. § 78fff-2(c).

[12] 15 U.S.C. § 78*lll*(2).

[13] 15 U.S.C. § 78*lll*(11).

[14] 17 C.F.R. § 1.20.

[15] 15 U.S.C. § 78eee(b)(2)(A).

[16] 17 C.F.R. § 190.00.

merchant on account of a commodity contract made, received, acquired, or held by or through such futures commission merchant in the ordinary course of such futures commission merchant's business as a futures commission merchant from or for a commodity contract account of such entity; or

(ii) [any] entity that holds a claim against such futures commission merchant arising out of —

— (I) the making, liquidation, or change in the value of a commodity contract of a kind specified in clause (i) of this subparagraph;

— (II) a deposit or payment of cash, a security, or other property with such futures commission merchant for the purpose of making or margining such a commodity contract; or

— (III) the making or taking of delivery on such a commodity contract . . . .[17]

"Customer property" generally encompasses property that the FCM segregated or should have segregated for the benefit of commodity contract customers,[18] and a customer's "net equity" claim generally captures the value of the customer's positions and associated margin, less any outstanding obligations of the customer to the FCM.[19] One notable difference from SIPA, however, is that the Part 190 contemplates separate "account classes" for the different types of commodities positions (*i.e.*, futures, cleared swaps and foreign futures) and provides that customers with claims on account of a particular account class have priority rights over other customers with respect to property segregated for that account class. Thus, futures customers have priority rights over other customers to claims for margin segregated for the benefit of futures customers, but subordinate rights to property segregated for the benefit of cleared swaps customers.

Accordingly, as with SEC Rule 15c3-3, the CFTC's segregation rules are designed to make sure that there is sufficient customer property available to satisfy customer claims in the event of an FCM's insolvency. To the extent property is pledged to third parties, such as a clearing agency, or otherwise unavailable, there may not be sufficient property to satisfy customer claims. Even with these protections, however, customers are exposed to fellow customer risk. If both an FCM and a large customer fail, the DCO will look to all collateral pledged to secure customer positions, including those of non-defaulting customers, to satisfy the FCM's obligations in relation to customer trades. This could result in losses to fellow customers.

3. *Consequences of Conflicting Segregation and Insolvency Rules*

Ultimately, these SEC and CFTC segregation rules preclude cross-margining by limiting the ability of a BD-FCM to grant the liens on the customer margin in favor of CME and FICC that would be necessary for a cross-margining arrangement. These limitations are designed to ensure that there is sufficient customer property available to satisfy customer claims in the event the BD-FCM becomes insolvent. However, as described in greater detail below, SIPA and the Part 190 rules can accommodate cross-margining arrangements, as long as the SEC and CFTC take steps to allow it.

III. A PATH FORWARD IN CROSS-MARGINING

As described above, both SIPA and the Part 190 rules generally describe both the scope of customer estate and the scope of customers entitled to protection by reference to the particular product group to which the regime relates. However, both regimes specifically contemplate and protect arrangements under which futures and securities positions are portfolio margined in a given account. For example, SIPA defines "customer" as including "any person who has a claim against the debtor for cash, securities, futures contracts, or options on futures contracts received, acquired, or held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the [SEC]."[20] Similarly, customer property and net equity are defined to include any portfolio margined positions and property and claims for the same.[21]

Likewise, the Part 190 rules provide that the "term customer includes the owner of a portfolio cross-margining account covering commodity contracts and related positions in securities (as defined in section 3 of the [Securities] Exchange Act [of 1934]) that is carried

[17] 11 U.S.C. § 761(9). 17 C.F.R. § 190.01 ("Customer means . . . [w]ith respect to a futures commission merchant as debtor . . . the meaning set forth in sections 761(9)(A) and (B) of the Bankruptcy Code.").

[18] 17 C.F.R. § 190.09.

[19] 17 C.F.R. § 190.08.

[20] 15 U.S.C. § 78*lll*(2).

[21] 15 U.S.C. §§ 78*lll*(4) and (11).

as a futures account . . . pursuant to an appropriate rule, regulation, or order of the [CFTC]."[22] As with SIPA, the Part 190 rules contain provisions that correspondingly ensure that "customer property" and "net equity" include any securities positions carried in a portfolio or cross-margining account.[23]

Accordingly, in the event the SEC or CFTC were to allow a BD-FCM to portfolio margin U.S. Treasury security positions with interest rate futures, SIPA or Part 190 would protect the positions and margin and customer claims therefor as though they had originally been securities or futures, respectively.

A. Market Professional Cross-Margining

Both the SEC and CFTC have issued orders relying on the protections afforded under Part 190 and SIPA to allow cross-margining arrangements. These orders have generally permitted BD-FCMs to carry customers positions in a futures account and benefit from the protections of Part 190. In order to provide legal clarity, they have required the relevant customers to expressly disclaim the rights of a customer under SIPA through a subordination agreement.

However, the SEC and CFTC have only extended the ability to cross-margin to "market professionals," which are defined to include specialists, market makers, and floor traders. In addition, the CFTC adopted rules that effectively created a separate "account class" for market professional positions under Part 190. This effectively means that, to the extent there were customer property segregated for the benefit of market professionals (*e.g.*, on account of a fellow customer default), market professionals' claims to the remaining pool of customer property would be subordinated to the claims of the BD-FCM's other customers.[24]

B. Expansion to all Intermediary Customers

The "market professional" exception allowed more market participants to benefit from reduced margin requirements that more accurately reflected their market risk. It also simultaneously encouraged central clearing and thereby reduced general market risk more effectively. However, the narrow scope of the market professional exception has limited the ability of many market participants to benefit from cross- margining arrangements and the market to benefit from reduced risk.

With respect to fellow customer risk, the CFTC's apparent rationale for this limitation is that cross-margining certain futures and securities positions through multiple CCPs somehow presents greater fellow customer risks than cross-margining futures with other futures positions. However, this argument does not make much sense, at least as applied to U.S. Treasury securities and interest rates. For one thing, the risk offsets between U.S. Treasury securities and interest rate futures are very clear and simple. One does not need to trace a long line of potential correlations. Second, the presence of two CCPs arguably provides a significant risk mitigant. Instead of one CCP calculating risk margin requirements on its own without particular oversight, the cross-margin requirement under the FICC-CME cross-margining program involves each CCP modelling and calculating the relevant margin requirement and then taking the lower of the possible margin reductions. Thus, the FICC-CME cross-margining arrangement should produce more risk sensitive results and thereby more accurate margin requirements.

The FICC does not historically have separate "customer" and "proprietary" accounts for its clearing members, but instead risk margins all of a given member's positions together (even if they are carried for the benefit of customers). This could in theory expose customers that participate in the cross-margining arrangement to the risks of the member's proprietary positions. However, the FICC can easily resolve this issue in connection with any cross-margining relief and

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[22] 17 C.F.R. § 190.01.

[23] 17 C.F.R. § 190.01.

[24] OCC-Intermarket Clearing Corporation ("ICC") Securities Exchange Act Release No. 34-30041 (December 5, 1991), 56 FR 68424 (December 12, 1991); OCC-ICC-CME Securities Exchange Act Release No. 34-32534 (June 28,1993), 58 FR 36234 (July 6, 1993); OCC-Board of Trade Clearing Corporation Securities Exchange Act Release No. 34- 32681 (July 27, 1993), 58 FR 41302 (August 3, 1993); OCC-Kansas City Board of Trade Clearing Corporation ("KCBOT") Securities Exchange Act Release No. 34-32708 (August 2, 1993), 58 FR 42586 (August 10, 1993); OCC-ICC-Commodity Clearing Corporation ("CCC") Securities Exchange Act Release No. 34-33272 (December 2, 1993), 58 FR 64997

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(December 10, 1993); OCC-ICC, OCC-ICC-CME, OCC-KCBOT Securities Exchange Act Release No. 34- 36819 (February 7, 1996), 61 FR 5594 (February 13, 1996); OCC-CME- Securities Exchange Act Release No. 34-38584 (May 8, 1997), 62 FR 26602 (May 14, 1997); and OCC-ICE Clear Securities Exchange Act Release No. 34-57118 (January 9, 2008), 73 FR 2970 (January 16, 2008).

agree that customer positions and margin can only be applied to obligations arising from transactions carried for customers.

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It is a simple matter to envisage solutions to concerns with cross-margining U.S. Treasury securities and interest rate futures, and easier to identify the myriad benefits that such cross-margining would bring to both individual market participants and the market generally. With market participants, regulators, and scholars calling for increased liquidity, resilience, and stability in the U.S. Treasury market, it is time to consider expanding existing cross-margining programs to U.S. Treasury securities and interest rate futures.[25] ■

[25] *See* footnote 1.

FIVE YEARS AFTER #METOO GOES MAINSTREAM

In the past five years the authors have seen investors continue to demand corporate accountability for sexual harassment. They discuss the cases making up this trend. They then turn to the Biden Agenda for Women and the SEC, which, they find, has made board diversity one of its top priorities. They close anticipating that securities litigation will remain a strong and effective tool in enabling investors to compel companies to meaningfully address sexual harassment and other forms of workplace misconduct.

By Rebecca Boon and Brittney Balser *

Five years ago, the MeToo movement founded by Tarana Burke went mainstream when Alyssa Milano asked people to tweet #MeToo if they had been sexually harassed or assaulted. By October 2017, #MeToo had reached 85 countries with 1.7 million tweets.[1] As millions of people came forward across industries with their personal accounts of misconduct, investors were listening.

Over the past half-decade, we have seen investors continue to demand corporate accountability for sexual harassment and other workplace misconduct. We have also seen boards of directors, for the first time, acknowledge that sexual harassment harms companies and that addressing sexual harassment culture is required as part of the fiduciary duties that boards owe to their shareholders. Investors have created and employed new methods to achieve meaningful corporate governance reforms through shareholder derivative lawsuits, direct securities fraud class actions, and proxy proposals from activist investors. Going forward, we expect this momentum to continue as shareholders demand progress and U.S. regulators, like the Securities and Exchange Commission, begin to meaningfully tackle ESG issues for the first time.

In the first successful case of its kind, investors brought a derivative lawsuit against the board of directors of Twenty-First Century Fox in the Delaware Court of Chancery to address allegations of sexual harassment perpetrated by Fox News' long-time CEO, Roger Ailes.[2] Through their investigation, investors uncovered an alleged widespread and damaging sexual harassment culture at Fox News that was not limited to one man, or a handful of instances, or an isolated period. After a year of litigation, shareholders resolved the case for $90 million, and together with the company implemented governance reforms designed to directly address the sexual harassment culture at Fox News. Most notably, the creation of the Fox News Workplace Professionalism and Inclusion Council brought together and empowered industry experts, together with company insiders, to identify and solve the problems at the company. Importantly, the Council publishes reports twice a year which Fox is obligated to post on its website for investors (and the world) to see, including minority reports if needed. The Council's broad powers and mandate ensure that change at the company will not be superficial and minimize the risk of regression. It has since served as a model for other companies' boards as they confront and work to fix these issues.

Investors also prosecuted the first successful securities fraud class action involving #MeToo allegations of sexual harassment against Signet Jewelers in the Southern District of New York.[3] In that case, hundreds of women had submitted declarations describing a pervasive culture of *quid pro quo* sexual harassment. Among other harrowing accounts, former employees who sought help or reported abuse through the company's existing internal hotline were often verbally attacked or terminated. Like Fox, Signet's CEO, Mark Light, was directly implicated in the misconduct. Light and other key executives were accused of promoting women based on whether they would accede to sexual demands, not merit, as the company falsely

[1] https://www.cbsnews.com/news/metoo-reaches-85-countries-with-1-7-million-tweets/.

[2] *City of Monroe Employs. Ret. Sys. v. Murdoch*, C.A. No.: 2017-0833-AGB, Del. Chan.

[3] *In re Signet Jewelers Ltd. Sec. Litig.*, No.: 16-cv-6728 (S.D.N.Y.).

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assured investors. Following more than a year of hard-fought litigation, plaintiffs ultimately reached a $240 million settlement of the claims. The settlement is notable because not only is it one of the 100 largest securities litigation settlements of all time,[4] but it was also the first successful prosecution of sexual harassment allegations through a securities class action litigation.

Building off the success of these #MeToo securities cases, investors have continued to use their power to hold corporations accountable and demand change. As one example, shareholders brought a derivative lawsuit against Alphabet (Google) in three jurisdictions alleging that Alphabet's board violated its fiduciary duties by allowing executives to sexually harass and discriminate against women.[5] Shareholders resolved the case for $310 million, and like Fox, achieved significant governance reforms, including the creation of a Diversity, Equity, and Inclusion ("DEI") Advisory Council responsible for overseeing the creation and implementation of DEI initiatives mandated by the settlement.

Most recently, shareholders successfully resolved claims against L Brands – the parent company of The Limited, Victoria's Secret, and Abercrombie & Fitch, in the Southern District of Ohio. There, an investigation into connections between the L Brands' founder and Jeffrey Epstein ultimately revealed alleged systemic sexual harassment and misconduct at the company.[6] Left unchecked for years, these problems allegedly resulted in a hostile, abusive culture that irreparably harmed L Brands. Investors resolved the case for $90 million and implemented significant governance reforms, including a DEI Council that would enhance training, invest in diverse communities, and audit the effectiveness of initiatives.

Similarly, investors have continued to prosecute direct securities fraud class actions involving #MeToo issues. For example, investors recently settled a securities fraud class action against CBS Corp. arising out of the Les Moonves scandal for millions of dollars (settlement pending final court approval).[7] Investors are also currently prosecuting a securities fraud class action against Activision after dozens of current and former employees spoke out about alleged abuse and sexism, and the California Department of Fair Employment and Housing filed a lawsuit against the company based on similar misconduct.[8] Among other things, the DFEH complaint alleges that Activision management allowed and encouraged sexual misconduct toward women employees, that the company maintained a "frat boy" culture, and that the company's hiring and employment practices discriminated against women.

These shareholder actions underscore that sexual harassment harms companies. A recent academic study found that companies with high incidences of sexual harassment claims underperformed the U.S. stock market by nearly 20% the subsequent year.[9] Additionally, a *Harvard Business Review* study found that a single sexual harassment claim can lower public perception of a company more dramatically than allegations of financial misconduct or fraud.[10]

As a result, we have also seen a recent increase in the role that activist investors are taking in combatting ESG issues, including #MeToo issues and allegations of sexual harassment. In late 2021, Microsoft came under intense scrutiny following allegations of sexual misconduct by founder and former-CEO Bill Gates. In response, activist investor group Arjuna Capital put forward a shareholder proposal asking Microsoft to transparently address the sexual harassment claims. Despite Microsoft's opposition, Arjuna Capital was able to achieve a majority shareholder vote on the proposal, and Microsoft hired a law firm to review its sexual harassment policies.[11] A public report of its findings is due later this year.

The Biden administration has also made ESG issues a top priority. Indeed, as part of his campaign platform, President Biden promised "an aggressive and comprehensive plan to further women's economic and physical security, and ensure that women can fully exercise their civil rights."[12] And the SEC is focused on

[4] ISS-SCAS, *The Top 100 U.S. Class Action Settlements of All-Time*, December 31, 2021.

[5] *In re Alphabet Inc. Shareholder Deriv. Litig.*, 19CV341522, (Cal. Super. Santa Clara Cnty.).

[6] *Rudi v. Wexner*, No. 20-cv-3068 (S.D. Oh.).

[7] *Construction Laborers Pension Trust for Southern California, et al. v. CBS Corporation, et al.*, No. 18-cv-07796 (S.D.N.Y.).

[8] *Cheng v. Activision Blizzard, Inc.*, No. 21-cv-6240 (C.D. Cal.).

[9] *The Real Cost of Workplace Sexual Harassment to Business*, The Conversation (September 2, 2019).

[10] *Research: How Sexual Harassment Affects a Company's Public Image*, Harvard Business Review (June 11, 2018).

[11] Sexual Harassment Proposal, Arjuna Capital (June 2021), https://static1.squarespace.com/static/5bc65db67d0c9102cca54b74/t/61a68b553ed02a77d1bdba2c/1638304597581/Sexual+Harassment+Proposal_Microsoft_2021_Arjuna+Capital.pdf.

[12] The Biden Agenda for Women, https://joebiden.com/womens-agenda/.

ESG through its ESG Task Force and recently proposed rulemaking on climate-related risk disclosures. The SEC has made board diversity and workplace diversity one of its top priorities. On August 6, 2021, the SEC approved Nasdaq's proposed rule changes related to board diversity and disclosure, which state that each Nasdaq-listed company must have at least two diverse board members or explain why it does not.[13] The standards will also require disclosure of information on the voluntary self-identified, gender, racial characteristics, and LGBTQ+ status of the company's board. As Commissioners Allison Herren Lee and Caroline A. Crenshaw stated, "We support the proposal because it represents a step forward for investors on board diversity."[14]

It is clear that combatting sexual harassment and promoting board diversity have become important and motivating issues for investors and regulators alike. In the past five years since #MeToo went mainstream, investors have successfully used securities litigation as a vehicle to enact much needed corporate governance reforms on multiple occasions. We anticipate the continued involvement of activist investors pursuing ESG-focused proposals following corporate misconduct and increased focus by the SEC on these issues, and we expect that securities litigation will remain a strong and effective tool in enabling investors to compel companies to meaningfully address sexual harassment and other forms of workplace misconduct. ■

[13] Securities and Exchange Commission, Release No. 34-92590 (August 6, 2021).

[14] *Statement on Nasdaq's Diversity Proposals – A Positive First Step for Investors*, Securities and Exchange Commission (August 6, 2021).