Testimony of

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Regarding

Discussion Draft: The Derivatives Market Transparency and Accountability Act of 2009

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I want to thank this Committee for inviting me to testify on the important issue that is before it today.

I also want to congratulate and thank Chairman Peterson, Ranking Member Lucas, the whole Committee, and the Committee staff for the Committee's continuing hard work, thoughtful analysis, and leadership that it has brought to bear on the widespread concerns that the deregulated over-the-counter derivatives market has caused the most serious financial distress in the Nation's economy since the Great Depression.

Since the summer of 2008, this Committee has repeatedly taken the leadership on regulatory issues of greatest concern to the American people. When gas prices were reaching over $4.00 a gallon by the end of June 2008, this Committee drafted on a day's notice and supervised the June 26, 2008 passage by a vote of 402 -19 emergency legislation that would have required the CFTC to implement emergency procedures in the crude oil futures markets to bring down the then sky rocketing price of gasoline, heating oil, and crude oil[1]. The Committee then drafted and supervised the passage by a 283-133 September 18, 2008 vote of the Commodity Markets Transparency Act of 2008, which was designed to bring transparency and accountability to the OTC energy markets, thereby stifling excessive speculation and unnecessarily high prices for America's energy needs.[2] Evidence adduced since the passage of this September 2008 legislation on the House floor has made it even clearer that excessive speculation in the unregulated energy and swaps markets has caused and continues to cause unnecessary and

[1] David Cho, "House Passes Bill Bolstering Oil Trade Regulator", Wash. Post, June 27, 2008, at D8 *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/06/26/AR2008062604005.html.

[2] Commodity Markets Transparency and Accountability Act, 110th Cong. (2008) *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d110:HR06604:@@@R.

substantial volatility in the agriculture and energy markets.[3] On January 14, 2009, for example, it was reported that, "[b]etween Christmas [2008] and a week ago oil prices soared 40 percent, only to reverse almost as sharply in recent days."[4] "The oil markets are suffering acute whiplash," said Daniel Yergin, an energy consultant and author of "The Prize," a history of world oil markets. "Price volatility is adding to the sense of shock and confusion and uncertainty."[5]

From October through December 2008, this Committee has held a highly productive, informative and widely publicized series of hearings on the role unregulated over-the-counter ("OTC") financial derivatives have played in causing the present economic meltdown. Now, under the leadership of Chairman Peterson, a new and comprehensive Discussion Draft of the Derivatives Markets Transparency and Accountability Act of 2009, this has been circulated for comment and is the subject of today's hearings. Again, that draft legislation is designed to apply time-tested tools of market regulation to the OTC agriculture, energy and financial derivatives markets.

There can be little doubt that the overwhelming message of the testimony presented to this Committee in its hearings on OTC derivatives has largely established a consensus that the previously unregulated OTC markets have caused severe systemic economic shocks to the economy, because of a lack of transparency to the Nation's financial regulators of these private bilateral agreements, and because of inadequate capital reserves set aside by OTC derivative counterparties to underpin the trillions of dollars of financial commitments they made (and are now owed) through the OTC transactions in question.

In almost all the credit markets examined, the derivative transactions have increased exponentially the risk and resulting indebtedness within the underlying markets. For example, New York Insurance Superintendent, Eric Dinallo, who has been responsible for overseeing two major troubled financial institutions that come within his regulatory ambit (AIG and MBIA), has demonstrated that outstanding credit default swaps ("CDS") "could total three times as much as

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[3] Michael Masters, Adam White, The Accidental Hunt Brothers (July 31, 2008) *available at* http://accidentalhuntbrothers.com/ (stating "[t]he total open interest of the 25 largest and most important commodities, upon which the indices are based, was $183 billion in 2004. From the beginning of 2004 to today, Index Speculators have poured $173 billion into these 25 commodities."); Maher Chymaytelli, Opec Calls for Curbing Oil Speculation, Blames Funds, January 28, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aw4VozXUOVwU (stating "Oil surged 46 percent in the first half of 2008 to a record $147.27 only to plunge by the end of the year… So-called net-long positions in New York crude futures by hedge funds and other large speculators betting on higher prices peaked at 115,145 contracts in March, according to data from the CFTC. They switched direction in July to a net-short position, or wager against prices, which reached 52,984 contracts by mid- November, the CFTC data show… Oil futures traded 6 cents down at $41.52 a barrel on the New York Mercantile….down 72 percent from last year's record."); The Price of Oil. (January 11, 2009). CBS: 60 Minutes

[4] Clifford Kraus, "Where Is Oil going Next, New York Times (January 14, 2009) B1 at http://www.nytimes.com/2009/01/15/business/worldbusiness/15oil.html

[5] *Id.*

the actual debt outstanding" in the markets for which the CDS provide guarantees.[6] In other words, because of "naked" credit default swaps that provide payouts to counterparties who have no interest insurable risk emanating from debts within these markets (i.e., they are simply wagering, for example, in exchange for a relatively small insurance-like premium, that subprime mortgages will not be paid off), the actual billions of dollars of losses in these markets have been magnified three fold by rampant and uncontrolled "betting" on these markets.[7]

By virtue of bailouts, guarantees, and loans (e.g., the FED exchanging Treasuries at its discount window for banks' troubled subprime assets) made by the United States Treasury and/or the Federal Reserve, the American taxpayer has been required to make good on unfulfilled or potentially unfulfilled commitments of our largest financial institutions in the OTC derivatives market of up to $6 trillion.[8] With the advent of the stimulus legislation and President Obama's soon to be announced overarching financial package, the American public's outlay will doubtless soon grow by further trillions of dollars through further possible guarantees, purchases of troubled assets (i.e. a "bad bank"), mortgage and other loans, and further capital infusions into the financial system.

Of course, the subject of today's hearing does not, and cannot, address the present multi-trillion dollar "hole" in our economy, which, in turn, has brought the world markets to their knees. This hearing and the legislation to which it is addressed is forward looking. The underlying thesis here is: if we are fortunate enough to dig ourselves out of the huge financial mire in which we find ourselves, a regulatory structure must be put in place that will prevent the risk creating and risk bearing folly that led to the present fiasco.

I have appended hereto a paper I prepared that outlines the severe damage unregulated OTC derivatives have caused to the market and that proposes a generic regulatory program designed to apply traditional and time tested tools of regulatory oversight now governing our equity, debt and regulated futures markets to our OTC derivatives markets. Suffice it to say, that I am in agreement with many who have already come before this committee and the Senate Agriculture Committee on these issues, including Terrence A. Duffy, Executive Chairman of the

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[6] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm., 110th Cong. at 3 (October 14, 2008) (*written testimony of *Eric Dinallo, Superintendent, New York State Insurance Dept.) available at* http://www.ins.state.ny.us/speeches/pdf/sp0810141.pdf.

[7] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm., 110th Cong. (October 14, 2008)* (stating "by 2000 we engaged in the Commodities Futures Modernization Act, which specifically did a few things. It made credit default swaps not a security, so it couldn't be regulated as a security; as you said, put it out of reach of the CFTC; and it said this act shall supersede and preempt the application of any state or local law that prohibits or regulates gaming or the operation of bucket shops.")

[8] David Leonhardt, The Big Fix, N.Y. TIMES (February 1, 2009), (stating that "the debt that the federal government has already accumulated […] is equal to about $6 trillion, or 40 percent of G.D.P. […] The bailout, the stimulus and the rest of the deficits over the next two years will probably add about 15 percent of G.D.P. to the debt. That will take debt to almost 60 percent, which is above its long-term average but well below the levels of the 1950s. But the unfinanced parts of Medicare, the spending that the government has promised over and above the taxes it will collect in the coming decades requires another decimal place. They are equal to more than 200 percent of current G.D.P.")

CME Group, Inc[9]; Eric Dinallo (the New York Insurance Superintendant)[10]; Professor Henry Hu, Professor of Law at the University of Texas Law School[11]; Professor William K. Black of the University of Missouri-Kansas City[12]; and Erik Sirri, Director of SEC's Division of Trading and Markets[13] as to the regulation of financial OTC derivatives; and Adam White [title][14] and Gerry Ramm [title] as to agriculture and energy OTC derivatives. Former Chair of the Federal Reserve, Paul Volker, has elsewhere made recommendations and observations consistent with the above referenced testimony[15], as has the January 29, 2009 Special Report on Regulatory Reform of the Congressional Oversight Panel mandated by the Emergency Economic Stabilization Act of 2008 ("the bailout legislation").[16] Finally, former SEC Chair Arthur Levitt has recommended reversal of the deregulatory effects of 2000 Commodity Futures Modernization Act on the OTC markets[17], and even former Fed Chair Alan Greenspan has admitted that it was an error to deregulate the credit default swaps market.[18]

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[9] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture*, 110th Cong. (December 8, 2008).

[10] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture*, 110th Cong. (November 20, 2008).

[11] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture*, 110th Cong. (October 15, 2008).

[12] *Role of Financial Derivatives in Current Financial Crisis: Hearing Before Senate Agricultural Comm., 110th Cong. (October 14, 2008).*

[13] *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture*, 110th Cong. (November 20, 2008).

[14] To Review Legislation Amending the Commodity Exchange Act: *Hearing Before the House Comm. on Agriculture, 110th Cong. (July 10, 2008).*

[15] Paul A. Volcker, Address to the Economic Club of New York, at 1-2 (April 8, 2008) available at econclubny.org/files/Transcript_Volcker_April_2008.pdf).

[16] CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY (2009).

[17] Goodman, The Reckoning: Taking Hard New Look at a Greenspan Legacy, N.Y. Times (October 9, 2008) available at http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?pagewanted=1&_r=1;

Michael Hirsh, The Great Clash of '09: A looming battle over re-regulation, Newsweek, (December 24, 2008) available at http://www.newsweek.com/id/176830**.**

[18] CONGRESSIONAL OVERSIGHT PANEL, 111TH CONG., SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY. (2009) at 7 (quoting former Federal Reserve Chairman Alan Greenspan "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

I am pleased that the draft legislation that we discuss today adopts most of the points made in my appended paper and the recommendations of the witnesses I have cited above.

In this regard, I support Discussion Draft's:

1. Requirement of mandatory clearing of OTC derivatives both through the CFTC or other appropriate federal financial regulators and by the CFTC exclusively in the energy and agriculture markets.
2. Reporting requirements and regulatory oversight obligations placed on designated clearing organizations ("DCOs").
3. Tailored, precise, and limited exemptions that may be granted by the CFTC to the mandatory clearing requirements for individually negotiated or, in the words of Goldman Sachs' E. Gerald Corrigan, "bespoke" derivatives, i.e., derivatives that by the instrument's limited reach and their unsuitability for trading cannot cause systemic risk to the nation's economy.
4. Imposition of speculative limits for non-commercial trading on designated contract markets ("DCMs"), designated transaction execution facilities ("DTEFs") and on other electronic trading facilities, as well as Foreign Boards of Trade, especially insofar as those speculation limits are recommended by Position Limit Advisory Groups composed in significant part by commercial hedgers within the relevant markets, i.e., those who have intimate knowledge of the degree of speculation needed in each market to provide liquidity.
5. Establishment of a clear and concise definition of a "bona fide hedging transaction" limiting that exclusion from speculation limits to those actually engaged as a primary business activity in the "physical marketing channel" of the commodity.
6. Imposition of three additional core principles to the criteria for establishing of a designated clearing organization ("DCO"): (1) disclosure of general information; (2) publication of trading information; and (3) fitness standards.
7. "Transition rule" requiring existing uncleared swaps or uncleared swaps executed for the period after enactment to establish the regulatory scheme to be required by the statute to be reported to the CFTC.
8. The banning of "naked" credit default swaps, i.e., those swaps that are merely a wager on the viability of an institution or financial instrument without requiring the corresponding underlying risk from the failure of those institutions or instruments.
9. The creation of an independent CFTC Inspector General confirmed by the Senate.
10. The appointment of at least 200 new full time CFTC employees.

With regard to my comments in support of the draft legislation, I want to particularly call attention to two commendable aspects of the legislation.

1. <u>The ban on "naked" credit default swaps</u>. Former SEC Chairman Christopher Cox has since September 2008 repeatedly criticized these instruments as "naked" shorts on public corporations that evade the requirements for shorting stocks in the regulated

equity markets.[19] He and the New York Insurance Superintendent, Eric Dinallo, have warned that these instruments encourage the "moral hazard" of providing perverse incentives to take actions that cause companies covered by the CDS to fail or, in the case of naked short of subprime mortgage paper, borrowers to default on their mortgage loans.[20] As to incentives of undercut the mortgage backed paper, i.e., mortgage backed securities or collateralized debt obligations, that has led many holders of CDS guarantees to oppose, for example, mortgage workouts so that mortgage defaults trigger "naked" CDS payments. Chairman Peterson had it exactly right when he recently said: "'It is hard for me to understand what useful purpose these things are serving, . . . I'm not out to get Wall Street, but what's gone on there is jeopardizing the world economy.'"[21] Those who support "naked" CDS argue that it is needed for "price discovery." However, the reported "short interest" on public companies in the regulated equities market already is an adequate "price discovery mechanism" for the worth of those companies. For price discovery on CDS guarantees of collateralized debt obligations, those CDS that insure actual risk on CDO investments should serve any needed price discovery function; to the extent that "real" CDS are inadequate for that purpose, the undisputed harm done to the economy by "naked" CDS far outweighs any price discovery benefits from allowing the continued trading of "naked" CDS. Had "naked" CDS been banned in the passage of the CFMA in 2000, it is my firm belief that there would have been no need for this hearing today in that the outlawing of that product, in and of itself, would have substantially mitigated the worldwide financial meltdown we are now experiencing.

2. Mandatory Clearing. While the financial services industry has supported the "availability" of clearing OTC derivatives as a "firewall" against systemic risk, they have, for the most part, opposed mandatory clearing. As has been explained in testimony by the CME Group, for example, a clearing facility, which is guaranteeing the performance of both counterparties to an OTC derivative contract, can only assume that substantial risk for performance for those contracts about which it has complete understanding. The requirement to understand contractual risk, *inter alia*, requires that the OTC cleared contracts be standardized, i.e., so that the clearing facility has substantial comprehension of the guarantor role it is playing. Those who oppose mandatory clearing worry about the inability to clear non-standardized OTC

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[19] O'Harrow and Denis, *Downgrades and Downfall*, Washington Post (December 31, 2008) A1 (stating "The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting on the current credit crisis,' Cox said, 'it is requires immediate legislative action.").

[20] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the SENATE AGRICULTURAL Comm., 110th Cong. 3 (October 14, 2008) (opening statement of Eric Dinallo, Superintendent, New York State Insurance Dept.)* (stating "We engaged in the ultimate moral hazard… no one owned the downside of their underwriting decisions, because the banks passed it to the Wall Street, that securitized it; then investors bought it in the form of CDOs; and then they took out CDSs. And nowhere in that chain did anyone say, you must own that risk.").

[21] Matthew Leising, Bloomberg.com, "Peterson Plans Bill to Force Credit Default Swaps Clearing"(December 15, 2008).

derivatives. As far back as 1993, however, the CFTC has promulgated a "swaps" exemption for individual negotiated swaps agreements that are not executed on an electronic trading facility.[22] Moreover, the draft legislation provides an arguably broader "individualized" exemption with the corresponding precise standards that assure that the exemption will only be granted when systemic risks will not be posed. In short, the draft legislation is a reasonable compromise that accommodates individually negotiated contracts that cannot be cleared. It should also be born in mind that the Senator Harkin's legislation flatly bans exceptions from his requirement that all OTC contracts be exchange traded – not merely cleared.[23] In this regard, the New York Stock Exchange has just advocated that "U.S. policy makers should extend existing [exchange] rules so that they apply to unregulated derivatives instead of drafting new legislation that may take years to implement, . . ."[24]

My only questions and/or comments on the draft legislation are:

1. <u>Express Pre-approval Findings of Suitability of Designated Clearing Organizations</u>. The CFMA sets out 14 core principles for the establishment of a DCO. As mentioned above, the discussion draft adds three new core principles borrowed from the core principles applicable to designated transaction execution facilities DTEFs (i.e. non-retail exchange trading for high net work institutions and individuals). However, as made clear by the CFTC's Director of Clearing and Intermediary Organizations, Ananda Radhakrishnan, under the Commodity Exchange Act, "DCOs do not need pre-approval from the CFTC to clear derivatives, [but] any such initiative would be required to comply with the relevant core principles set forth in the [statute] and the CFTC would review it for compliance with those principles. . . ."[25] In other words, the statute allows facilities to self certify as DCOs and the CFTC would only then examine compliance with core principles after the fact. As is now well known, the CFTC "announced" on December 23, 2008 that "the CFTC staff would not object to the [DCO] certification."[26] The CME submitted its plans to the CFTC staff prior to the operation of its DCO. The "CFTC staff reviewed CME's plans to clear credit

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[22] 17 C.R.F. Part 35 (1993).

[23] *The Derivatives Trading Integrity Act*, 111th Cong. (January 15, 2009); Senate Agriculture Comm., Statement of Chairman Tom Harkin: Role of Financial Derivatives in the Current Financial Crisis (Oct. 14, 2008); Posting of James Hamilton to Jim Hamilton's World of Securities Regulation, http://jimhamiltonblog.blogspot.com/2009/01/senate-bill-would-regulate-otc.html (Jan. 17, 2009, 14:58) (stating "[t]he broad goal of the [Senator Harkin's] legislation is to establish the standard that all futures contracts trade on regulated exchanges.").

[24] Lisa Brennan, "Exchange Rules Should Apply to Derivatives, NYSE Says" (Bloomberg, February 2, 2009).

[25] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm., 110th Cong. 3 (October 14, 2008).*

[26] Press Release, Commodity Futures Trading Commission, CFTC Announces That CME Has Certified a Proposal to Clear Credit Default Swaps (Dec. 23, 2008) *available at* http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5592-08.html.

default swaps, including CME's planning risk management procedures, . . ."[27] My search of the CME docket number on the CFTC web site shows no accompanying order by the Commission or the CFTC staff indicating or explaining such approval. I hasten to add that I have little doubt about the qualifications (or indeed the great benefit) of the CME, the world's largest derivatives exchanges, engaging in this clearing. However, others are eligible to apply for DCO status and in an age when the American public is clamoring for transparency in governmental actions, especially actions surrounding the present financial crisis, and given the great importance of approving an institution to clear these highly volatile and potentially toxic products, it would seem that pre-approval of a clearing facility should be required and that the Commission –not just the staff – should issue affirmative and detailed findings about its confidence in the applicant serving as a DCO. Indeed, prior to the passage of the CFMA in December 2000, the CFTC and its staff issued 18 single space pages of detailed findings endorsing the safety and soundness of the first applicant to clear swaps.[28] Since the CFTC staff checks the safety and soundness of a DCO one way or another, the Committee should add a provision to the legislation requiring pre-approval of DCOs trading OTC derivatives and that that pre-approval be accompanied by findings demonstrating that the DCO applicant meets all applicable statutory requirements. Given the importance of the clearing facility in serving as a firewall against breakdown of the economy, it seems a small burden to require a transparent Commission document reflecting its careful attention this important decision.

2. Fraud and Manipulation. As the CFMA is presently drafted, the swaps exemption in section 2 (g) of the Act excludes swaps from the anti-fraud and anti-manipulation provisions within the statute.[29] (This exclusion distinguishes itself from "exempt" commodities, e.g., energy futures, which are subject to the Act's fraud and manipulation prohibitions.) Senator Harkin's legislation, S. 272, by requiring the exchange trading of swaps and the elimination of "exemptions" and "exclusions" brings the swaps market within the umbrella of the Act's central fraud and manipulation prohibitions. As Patrick Parkinson (Deputy Director, Division of Research and Statistics of the Federal Reserve System) made clear in his November 20, 2008 testimony before this Committee, the President's Working Group on Financial Markets is advising that OTC clearing facilities qualifications be measured against the "Recommendations for Central Counterparties" of the Committee on Payment and Settlement Systems of which Mr. Parkinson was the Co- Chair and on

[27] *Id.*

[28] Order Granting the London Clearing House's Petition for an Exemption Pursuant to Section 4(c) of the Commodity Exchange Act, 64 Fed. Reg. 53346-64 (October 1, 1999).

[29] Johnson & Hazen, Derivatives Reg., section 1.18[6][B] at p. 332 (2004 ed.) "[U]nlike excluded transaction, with exempt off-exchange transactions [, exempted transactions and swaps transactions], the CFTC retains its enforcement authority in case of fraud or market manipulation." Interpretation of CEA §§2(c), 2(d) and 2(g).

which the CFTC and SEC served.[30] Those recommendations are replete with concerns about combating fraud in the clearing process. In the present climate of American public's distrust of financial markets, OTC swaps, as is true of "exempt" futures, should be subject to fraud and manipulation prohibitions. Moreover, it would seem to be a difficult argument to make that, whereas swaps should be cleared, fraud and manipulation should not be barred or, conversely, that logic would seem perversely to dictate that fraud and manipulation be permitted.[31]

3. Important Inconsistency between Sections 6 and 9 of the Discussion Draft. As I read Section 6 (2) (A) of the Discussion Draft, it requires that the CFTC "shall . . . establish limits on the amount of positions, as appropriate, other than bona fide hedge[rs] that may be held by any person with respect to . . . commodities traded . . . on an electronic trading facility as a significant price discovery contract." Section 6 (B) (i) and (iii) mandate that these limits "shall be established" within set time periods for "exempt commodities" and "excluded commodities." Exempt commodities include over-the-counter energy futures contracts exempt from regulation by § 2 (h) of the CEA. Excluded commodities cover swaps are exempt under § 2 (g). Therefore, it would seem that Section 6 of the Discussion Draft mandates the imposition of position limits on OTC "exempt" and "excluded" trading. Moreover, Section 6 seems, by the breadth of its language, to authorize implicitly the CFTC to impose aggregated limits across contract markets for specified commodities. On the other hand, Section 9, by its terms, appears to require the CFTC to "study" each of these issues already addressed in Section 6 and to report back to this Committee within one year of enactment. Given the overwhelming evidence that has been gathered about the impact of excessive speculation on the energy futures and energy swaps markets[32], for example, Section 9 should be struck from that statute, because the time for study has long since passed. Moreover, I would urge this Committee to follow the bi-partisan lead of Senators Reid, Lieberman and Collins[33] and require – not simply authorize – the CFTC to impose aggregated speculation limits upon U.S. traders and those trading in the U.S. across the energy and agriculture contract markets. It should be emphasized that on July 26, 2008 [check date] the Reid bill garnered 50 of 93 Senate

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[30] Patrick M. Parkinson, Statement of Testimony before the Committee on Agriculture United States House of Representatives on November 20, 2008, he stated that "We [the CFTC, SEC, and Federal Reserve] have been jointly examining the risk management and financial resources of the two organizations that will be supervised by U.S. authorities against the 'Recommendations for Central Counterparties,' a set of international standards that were agreed to in 2004 by the Committee on Payment and Settlement Systems of the central banks of the Group of 10 countries and the Technical Committee of the International Organization of Securities Commissions," *available at* http://agriculture.house.gov/testimony/110/h91120/Parkinson.pdf.

[32] *Supra* at n. 3.

[33] See S.3044, "Consumer-First Energy Act", 110th Congress, Sponsored by Sen. Henry Reid. See Also S.3248, "Commodity Speculation Reform Act", 110thCongress, Sponsored Sen. Joseph Lieberman, Sen. Christopher Bond, Sen. Maria Cantwell and Sen. Susan Collins. "

votes in the last Congress in an unsuccessful attempt to sustain cloture in the last Congress.[34] Again, given the heightened evidence of excessive speculation in the crude oil markets that post-date that July 26th vote, it could be expected that the 60 votes needed to bring the Reid aggregate spec limits bill to a vote on the merits will be reached in this Congress. My understanding is that this Committee will receive testimony from a broad coalition of industrial consumers of energy, including the airlines, truckers, farmers, heating oil dealers, and petroleum marketers, strongly backing the inclusion of aggregated spec limits for energy and agriculture in any bill reported out by this Committee.

4. Standards for Approving a Designated Clearing Organization. As stated above, I support the Discussion Draft's addition of three core principles to the statute's 14 criteria governing the approval of DCOs. I have also recommended above that the Commission – and not just the CFTC staff – make detailed pre-approval findings that the applicant for DCO status meets the criteria for clearing OTC derivatives. Again, the approval process is critical because it is universally recognized that a "risk management failure by a [clearing facility] has the potential to disrupt the markets it serves and . . . [cause] disruptions to securities and derivatives markets and to payment and settlement systems, . . ." A mistaken decision by the CFTC about the appropriateness of an applicant to serve as a DCO will simply recreate the instability of the present system where counterparties – even counterparties rated AAA at the commencement of the derivatives transactions – were ultimately downgraded and not able to fulfill their contractual obligations. The DCO approval decision requires great sophistication. Three years ago, many then AAA rated institutions, such as Lehman, Bear Stearns, or AIG, would have very likely been deemed strong DCO candidates. In short, today's AAA rated institution may be tomorrow's undercapitalized and overwhelmed entity whose failure will undermine the OTC derivatives settlement process; and possibly the Nation's economy as a whole. The Fed's and the SEC's reliance, for example, on the intricately detailed CPSS's "Recommendation for Central Counterparties," raises the question whether the CFMA's generalized DCO approval criteria – even as supplemented by the Discussion Draft's three additional criteria – are detailed enough to ensure that only the most prudent and stable entities to clear OTC derivatives. If the CPSS's recommendations are more thorough in this regard (they are certainly more detailed), adoption of the CPSS's standards by other committees of Congress for their regulators, may become a pretext to seek the removal of the CFTC from clearing approval authority. The CPSS recommendations should be studied to ensure that that the DCO criteria are complete.

It is for that reason that my preference would be to adopt exchange trading criteria to OTC derivatives as is required by S. 272. The New York Stock Exchange has also recently supported an exchange based approach.[35]The statutory requirements for a

[34] Record Vote Number: 146, 110th Congress (June 10th, 2008). Cloture motion rejected – 51 Yeas, 43 Nays, 6 Not voting. The four supporting republicans were, Collins (R-ME), Smith (R-OR), Snowe (R-ME) and Warner (R-VA).

[35]*Supra* at n. 24.

designated transaction execution facility are more rigorous than those for a DCO even as those DCO criteria are upgraded by the discussion draft. DCOs are not expressly required to establish net capital requirements or financial integrity standards for counterparties;[36] there is no regulation of DCO intermediaries as is true in the case of DTEFs;[3738] unlike DTEFs, the emergency authority of a DCO is expressly limited to withstanding "disasters" which in context of the statute is appears to be limited to natural disasters or Y2K types of information technology problems and not the threat of a systemic meltdown of the facility as a whole ;[39] and there is no requirement for self regulation of DCOs as is true of DTEFs.[40] Finally, while it is true that DTEFs, unlike Designated Contract Markets ("DCM"), do not expressly have to establish dispute resolution mechanisms, this would be a worthy requirement to be applied to DCOs dealing with the highly volatile OTC derivatives markets.[41]

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[36] *Compare* 7 U.S.C. § 7a (b)(3)(B)(iv) (2008) (stating the minimum net capital requirements for a party to trade on a registered DTEF) *and* 7 U.S.C. § 7a (c)(4) (2008) (mandating that DTEF boards of trade must "establish and enforce rules or terms and conditions providing for the financial integrity" of both participants and transactions entered on or through the board of trade) *to* 7 U.S.C. § 7a-1 (c)(2)(C)(i) (2008) (merely requiring "appropriate minimum financial requirements" for admission and continued eligibility, but providing no explicit standards).

[37] Intermediaries, such as futures commission merchants, depository institutions, and Farm Credit System Institutions, must meet certain requirements in order to interact with a DTEF. 7 U.S.C. § 7a (e)(1) (2008). The intermediary must be in good standing with the SEC or the Federal bank regulatory agencies (whichever is appropriate. 7 U.S.C. § 7a (e)(2)(A) (2008). Additionally, if the intermediary holds customer funds for more than a day, it must be registered as futures commission merchant and must be a member of a registered futures association. 7 U.S.C. § 7a (e)(2)(B) (2008). There is no statutory equivalent for DCOs concerning FCMs, depository institutions Farm Credit Institutions, or any other type of intermediary. *See generally* 7 U.S.C. § 7a-1 (2008).

[38] *See* 7 U.S.C. § 7a (d)(7) (2008) (stating that "the board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members, and any other persons with direct access to the facility, including any parties affiliated with any of the persons described in this [statute]."). There is no comparable requirement for DCOs. *See generally* 7 U.S.C. § 7a-1 (2008).

[39] 7 U.S.C. § 7a-1 (c)(2)(I)(ii) (2008) (requiring the maintenance of emergency procedures , a disaster recovery plan, and periodic testing of backup facilities, but not the establishment of a contingency plan to deal with economic emergencies).

[40] While both DTEFs and DCOs have various requirements that they are responsible for carrying out, it is only in the context DTEFs that the concept of "self regulation" is expressly addressed. *See* 7 U.S.C. § 7a (b)(2)(E) (2008) (noting that the Commission will consider the entities history of this self regulation when determining if there is a threat of manipulation); *see, e.g.,* 7 U.S.C. § 7a (d)(2008) (explaining the core principles and explicit duties of a DTEF); 7 U.S.C. § 7a-1 (c)(2) (2008) (listing in broad terms the responsibilities of a DCO).

[41] However, it is worth noting that:

> a board of trade may elect to operate as a registered derivatives transaction execution facility if the facility is--
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> (1) designated as a contract market and meets the requirements of this section; or
>
> (2) registered as a derivatives transaction execution facility under subsection (c) of this section.

In sum, the Committee should be congratulated for the scope of its hearings on these critically important questions and for the thoroughness of the Discussion Draft.

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7 U.S.C. § 7a (a)(1)-(2) (2008).

If the DTEF chose to operation under section (1), it follows that the board of trade would be obligated to follow all of the requirements for a DCM.

Appendix A

Memorandum
on
Regulatory Reform of Credit Default Swaps
Professor Michael Greenberger
January 24, 2009

While a litany of factors including lending and financial abuses led to the present economic meltdown, chief among them was the opaque nature of the estimated notional $596 trillion[1] unregulated over-the-counter derivatives market. That market includes what is estimated to be the $35-65 trillion credit default swaps ("CDS") market.[2] The over-the-counter derivatives market was, prior to December 20, 2000, conventionally understood to be subject to regulation under the Commodity Exchange Act ("CEA"). On that date, the Commodity Futures Modernization Act ("CFMA") was passed. That legislation was, for the most part, rushed through Congress and enacted during a lame duck session as a rider to an 11,000 page omnibus appropriation bill.[3] That statute removed swaps transactions from all meaningful federal oversight.

In warning Congress about badly needed reform efforts when it considered the bailout legislation in Senate hearings before the Senate Banking Committee in September, 2008, SEC Chairman Christopher Cox called the CDS market a "regulatory blackhole" in need of "immediate legislative action."[4] Former SEC Chairman Arthur Levitt and even former Fed Chair Alan Greenspan have acknowledged that the deregulation of the CDS market contributed greatly to the present economic downfall.[5]

In brief, the securitization of subprime mortgage loans evolved from simple mortgage backed securities ("MBS") to highly complex collateralized debt obligations ("CDOs"), which were the pulling together and dissection into "tranches" of huge numbers of MBS, theoretically designed to diversify and offer gradations of risk to those who wished to invest in that market.

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[1] See, Bank for International Settlements, BIS Quarterly Review (September, 2008), *available at* http://www.bis.org/publ/qtrpdf/r_qa0809.pdf#page=108

[2] *Id.*

[3] See, e.g., Johnson & Hazen, Derivatives Regulation, § 1.17 at 41-49 (2009 Cum. Supp.)

[4] "'The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting on the current credit crisis,' Cox said, 'it is requires immediate legislative action.'" O'Harrow and Denis, Downgrades and Downfall, Washington Post (December 31, 2008) A1.

[5] Goodman, The Reckoning: Taking Hard New Look at a Greenspan Legacy (October 9, 2008) A1; http://mobile.newsweek.com/detail.jsp?key=39919&rc=camp2008&p=0&all=1

However, investors became unmoored from the essential risk underlying loans to non-credit worthy individuals by the continuous reframing of the form of risk (e.g., from mortgages to MBS to CDOs); the false assurances given by credit rating agencies that gave misleadingly high evaluations of the CDOs; and, most importantly, by the "insurance" offered by CDO issuers in the form of CDS. The CDS "swap" was the exchange by one counter party of a premium for the other counterparty's "guarantee" of the financial stability of the CDO. While CDS has all the hallmarks of insurance, issuers of CDS were urged not to refer to it as "insurance" out of a fear that CDS would be subject to insurance regulation by state insurance commissioners. By using the term "swaps," CDS fell into the regulatory blackhole afforded by the CFMA.

Because CDS was not insurance or any other regulated instrument, the issuers of CDS were not required to set aside adequate capital reserves to stand behind the guarantee of the financial stability of CDOs. The issuers of CDS were beguiled by the utopian view (supported by ill considered mathematical algorithms) that housing prices would always go up and that, even a borrower who could not afford a mortgage at initial closing, would soon be able to extract that appreciating value in the residence to refinance and pay mortgage obligations. Under this utopian view, the writing of CDS was deemed to be "risk free" with a goal of writing as many CDS as possible to develop cash flow from the "premiums."

To make matters worse, CDS was deemed to be so risk free (and so much in demand) that financial institutions began to write "naked" CDS, i.e., offering the guarantee to investors who had no risk in any underlying mortgage backed instruments or CDOs. Naked CDS provided a method to "short" the mortgage lending market, i.e., to place the perfectly logical bet for little consideration (i.e. the premium) that those who could not afford mortgages would not pay them off. The literature surrounding this subject estimates that more "naked" CDS instruments are extant than CDS guaranteeing actual risk.

Finally, the problem was further aggravated by the development of "synthetic" CDOs. Again, these synthetics were mirror images of "real" CDOs, thereby allowing an investor to play "fantasy" securitization. That is, the purchaser of a synthetic CDO does not "own" any of the underlying mortgage or securitized instruments, but is simply placing a "bet" on the financial value of a the CDO that is being mimicked.

Because both "naked" CDS and "synthetic" CDOs were nothing more than "bets" on the viability of the subprime market, it was important for this financial market to rely upon the fact that the CFMA expressly preempted state gaming laws.[6]

It is now common knowledge that: (1) issuers of CDS did not (and will not) have adequate capital to pay off guarantees as housing prices plummet, thereby defying the supposed "risk free" nature of issuing huge guarantees for the small premiums that were paid; (2) because

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[6] Johnson & Hazen, Derivatives Regulation, §4.04[11] at 975 (2004 ed) referencing 7 U.S.C. § 16 (e) (2).

CDS are private bilateral arrangements for which there is no meaningful "reporting" to federal regulators, the triggering of the obligations there under often come as a "surprise" to both the financial community and government regulators; (3) as the housing market worsens, new CDS obligations are triggered, creating heightened uncertainty about the viability of financial institutions who have or may have issued these instruments, thereby leading to the tightening of credit;; (4) the issuance of "naked" CDS increases exponentially the obligations of the CDS underwriters; and (5) the securitization structure (i.e. asset backed securities, CDOs and CDS) is present not only in the subprime mortgage market, but in the prime mortgage market, as well as in commercial real estate, credit card debt, and auto and student loans. As these latter parts of the economy falter, the toxicity of the underlying financial structure falls into a continuous destabilizing pattern. As a result, for example, the Fed is now spending $200 billion to buy instruments outside of the residential mortgage market.[7]

Finally, while CDS and synthetic CDOs constitute the lit fuse that leads to the exploding financial destabilization we are experiencing today, the remainder of the over-the-counter derivatives market has historically led to other destabilizing events in the economy, including the recent energy and food commodity bubble (energy and agriculture swaps), the failure of Long Term Capital Management in 1998 (currency and equity swaps), and the Bankers Trust scandal and the Orange Country bankruptcy of 1994 (interest rate swaps).

Because "swaps" are risk shifting instruments or, in their most useful sense, hedges against financial risk, they were almost certainly subject to the Commodity Exchange Act prior to the passage of the CFMA in 2000. The Commodity Future Trading Commission ("CFTC") in 1993 exempted swaps from that CEA's exchange trading requirement if their material economic terms were individually negotiated and if they were not traded on a computerized exchange.[8] However, the 1993 exemption did not satisfy the financial services sector and, by 1998, the market grew to over $28 trillion in notional value without utter disregard for the exchange trading requirements within the CEA.

As a result in May 1998, the CFTC, under the leadership of then Chair Brooksley Born, issued a "concept release" inviting public comment on how that multi-trillion dollar industry might most effectively be covered by the CEA on a "prospective" basis.[9] While that effort was blocked by the Executive Branch and Congress (including the passage of the CFMA in 2000), the CFTC concept release spelled out a menu of regulatory tools that have historically been

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[7] GAO Report, supra note 17, at 31; Press Release, Federal Reserve, Nov. 25, 2008, *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm

[8] 17 C.R.F. Part 35 (1993).

[9] 63 Fed. Reg. 26114 (May 12, 1998)

applied to financial instruments, e.g., equities, bonds, and traditional futures contracts that have the financial force to destabilize the economy systemically.

The classic indicia of regulation of financial instruments that have potential systemic adverse impacts on the economy include:

1. Transparency. These kinds of financial instruments are reported to, and, even often, registered with, a federal oversight agency prior to execution. Transparency also requires that all transactions and holding be accounted for on audited financial statements. The present meltdown has been characterized by the use of off balance sheet investment vehicles, e.g., structured investment vehicles ("SIVs") to house those instruments with potential systemic risk hidden from public view.

2. Record Keeping. Counterparties should be required to keep records of these transactions for 5 years.

3. Immediate Complete Documentation. Since August 2005, the Fed has complained that financial instruments pertaining to credit derivatives have been poorly documented with back offices being very far behind the execution of credit derivatives by sales personnel.

4. Capital Adequacy. Federal regulators traditionally require that parties to regulated transactions have adequate capital reserves to ensure payment obligations.

5. Disclosure. Federal regulators traditionally require full and meaningful disclosure about the risks of entering into the regulated transaction.

6. Anti-fraud authority and anti-manipulation. The regulated markets are governed by statutes that bar fraud and manipulation. The CFMA provided only limited fraud protection for counterparties by the SEC. The inadequacy of that protection is evidenced by both SEC Chairman Cox and former SEC Chairman Levitt calling regulation of these markets a "regulatory blackhole."[10] Fraud protection without transparency to the federal regulator is meaningless. Moreover, no manipulation protection was included within the CFMA with regard to swaps. Effectively, the CFMA authorized this massive multi-trillion dollar worldwide swaps market without any provisions for protecting against fraud or manipulation. Fraud and anti-manipulation protections included within the securities and regulated futures laws should be restored to these markets.

[10] *See* Speech by SEC Chairman Christopher Cox: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008).

7. Registration of Intermediaries. "Brokers" of equity and regulated futures transactions are subject to registration requirements and prudential conduct. There is no such protection within the swaps market.

8. Private Enforcement. As is true in securities laws and laws applying to the regulated futures markets, private parties in the swaps markets should have access to federal courts to enforce anti-fraud and anti-manipulation requirements, thereby not leaving enforcement entirely in the hands of overworked (and sometimes unsympathetic) federal enforcement agencies.

9. Mandatory Self Regulation. As is true of the securities and traditional futures industries, swaps dealers should be required to establish a self regulatory framework, including market surveillance.

10. Clearing. Again, as is true of the regulated securities and regulated futures infrastructure, a strong clearing intermediary should clear all trades as further protection against a lack of creditworthiness of counterparties.

The adoption of the traditional regulatory protections for swaps with systemic risk characteristics would essentially return these markets to where they were as a matter of law prior to the passage of the CFMA in 2000. The general template would be that swaps would have to be traded on a regulated exchange (which provides each of the protections outlined above) unless the proponents of a risk shifting instrument bear the burden of demonstrating to a federal regulator that the instrument cannot cause systemic risk and will not lead to fraudulent or manipulative practices if traded outside an exchange environment. It is for that reason, for example, that, in 1993, the CFTC exempted from exchange trading requirements privately negotiated contracts not traded in standardized format.

The Senate Chair of the committee of jurisdiction over swaps, Senator Harkin[11] , has argued that trading in these instruments should be moved back onto regulated exchanges and he even posed the possibility of an outright ban on "naked" CDS. In

[11] Lynch, Harkin Seeks to Force All Derivatives on Exchanges, Wall Street Journal November 20, 2008 at http://online.wsj.com/article/SB122721812727545583.html. See also Hunton & Williams LLP, *The Derivatives Trading Integrity Act - Beginning of the End for OTC Trading?*, December 2008, *available at* http://www.hunton.com/files/tbl_s10News%5CFileUpload44%5C15843%5Cderivatives_trading_integrity_act.pdf ("Senate Agriculture Committee Chairman Tom Harkin (D-Iowa) introduced the Derivatives Trading Integrity Act of 2008 ("the Bill"), hoping to end "casino capitalism" in the market for over-the-counter (OTC) derivatives. The Bill amends the Commodity Exchange Act (CEA) to require that all contracts with future delivery trade on regulated exchanges similar to how commodity futures currently trade...The Bill reverses [the CFMA], forcing swap transactions to be conducted on designated or registered clearing houses or derivatives clearing organizations.").

other words, he has called for reversing the CFMA in this regard and returning to the regulated exchange trading environment with direct federal oversight and self regulatory protections that existed prior to the passage of the CFMA.

Three final points should be made.

Simple Clearing Is Not Enough. The financial services industry and the Bush Administration have argued that clearing facilities for CDS will provide adequate regulation. Clearing proposals have been advanced to the FED, the SEC, and the CFTC, where they are in various stages of approval. As I understand it, the clearing is wholly voluntary. Second, clearing without each of the other regulatory attributes outlined above, while helpful, does not provide a systemic risk firewall. Stocks and traditional futures trading have a complete regulatory infrastructure built around the clearing process. For example, we would never settle for clearing, and clearing alone, as a substitute for the regulatory and self regulatory structure that surrounds the equities market.

Moreover, clearing without other prudential safeguards just places an apparently sound financial institution as the guarantor of the counterparties. Five years ago, AIG might have convincingly advanced itself as such an institution. Similarly, a AAA entity that appears sound today may become unstable if the entire derivatives market is not adequately policed. In sum, the limited step of clearing by itself does not adequately protect against systemic risk.

State Insurance Regulation. As mentioned above, CDS has all of the attributes of insurance. As a result, the New York Insurance Superintendant and the Governor of New York in September 2008 required that its insurance registrants trading CDS to those wanting to indemnify their own real risks in the mortgage market be subject to state insurance law by January 1, 2009 with corresponding capital adequacy requirements.[12] In this vein, it is interesting to note that AIG, a New York insurance regulatee, had $20 billion in reserve for each of its regulated insurance subsidiaries at the time it was rescued by the U.S. on September 17, 2008, because of CDS trading in an unregulated portion of the company. That fact seems to be unanswerable vindication of the efficacy of state insurance regulation, which is even now *not* preempted by the CFMA. In November 2008, New York temporarily suspended the CDS mandate it had issued in September on

[12] New York State Insurance Dept., Recognizing Progress By Federal Government In Developing Oversight Framework For Credit Default Swaps, New York Will Stay Plan To Regulate Some Credit Default Swaps, press release, November 20, 2008 ("Dinallo announced that New York had determined that some credit default swaps were subject to regulation under state insurance law and that the New York State Insurance Department would begin to regulate them on January 1, 2009.").

the theory that the prospects for federal regulation had improved.[13] On January 24, 2009, the National Conference of Insurance Legislators is holding a hearing in New York City to discuss whether CDS should be subject to state regulation. My view is that state efforts in this should be encouraged as a further safeguard against systemic risk, especially insofar as the CFMA itself did not preempt state insurance laws. The CFMA limited its preemptive effect to state gaming and bucket shop laws.

As some commentators have also made clear, the New York Insurance Superintendant's proposed extension to of New York insurance law relating to those seeking to indemnify actual risks from the actual holding of CDOs is too limited. "Naked" CDS, or the guarantees to counterparties who hold *no* CDO risk and who just want to bet against mortgage commitments being fulfilled, are the kind of insurance that led to the creation of state insurance laws.[14] Under state insurance laws, you cannot insure against someone else's risk. Insurance of that kind creates so-called "moral hazard," or the creation of perverse and nonproductive incentives to take actions that will lead to the triggering of the insurance guarantee. For example, the holder of a "naked" CDS might want to interfere with mortgage "work outs" to avoid defaults on loans, thereby insuring that the "guarantee" against loan default within the naked CDS will be triggered. Accordingly, if states are to regulate here, they should bar "naked" CDS as the very kind of unlawful insurance that caused regulation in this area.

Finally, there is a strong "regulatory reform" movement to preempt some or all of state insurance law in favor of a federal insurance regulator.[15] If the states "stand down"

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[13] New York State Insurance Dept., Recognizing Progress By Federal Government In Developing Oversight Framework For Credit Default Swaps, New York Will Stay Plan To Regulate Some Credit Default Swaps, press release, November 20, 2008 (Superintendent Dinallo stating "I am pleased to see that our strong stand has encouraged the industry and the federal government to begin developing comprehensive solutions. Accordingly, we will delay indefinitely regulating part of the market.").

[14] Kimbal-Stanley, Arthur , *Dissecting A Strange Financial Creature,* The Providence Journal, April 7, 2008 ("Insurance contracts used to protect against the loss of property owned by the person buying the policy helped the buyer eliminate the consequences of calamity. Insurance contracts used to bet on whether or not calamity would befall someone else's property not only let the buyer place a bet, it gave the buyer incentive to make that calamity occur, to destroy the insured property he did not own, to sink the other guy's ship, in order to collect on an insurance contract. In 1746, Parliament passed the Marine Insurance Act, requiring anyone seeking to collect on an insurance contract to have an interest in the continued existence of the insured property. Thus was born the insured-interest doctrine….The doctrines have been part of insurance law in both England and the United States (which in 1746 were colonies under English common law) ever since.").

[15] Insurance Journal, *AIG Crisis Restarts Debate Over State vs. Federal Insurance Regulation*, September 17 2008, *available at* http://www.insurancejournal.com/news/national/2008/09/17/93798.htm?print=1

on the CDS market, i.e., consciously decide not to regulate products that have all the elements of insurance, in favor of exclusive federal regulation, that will be the first exhibit used by those advocating federal regulation as to the purported inadequacy of state regulation. CDS represent class insurance products.[16]

Structural Regulation Alone. A further school of thought, most clearly evidenced by the President's Working Group on Financial Markets "regulatory reform" proposal of March 2008, is that the present regulatory failures have been caused by structural inadequacies, e.g., too many regulators looking at huge institutions carrying out in a single structure a host of financial activities.[17] The March 2008 proposal was intended to mimic the U.K.'s then extant unified regulatory structure that was premised on "principles" rather than "rules." For example, the March 2008 proposal would merge the CFTC into the SEC, but have the SEC use the CFTC's "principles" based regulation. Moreover, the March 2008 proposal would hand over to the Fed considerable consolidated "rescue" powers. It may very well be that there needs to be a restructuring of the federal regulatory system. However, the adverse lesson emanating from the creation of the Department of Homeland Security should be an object lesson in the dangers of governmental reorganization in a time of crisis. More importantly, it is not enough to improve federal "rescue" capabilities. There are neither principles nor rules that govern the OTC derivatives market. It is a "blackhole." Even the U.K. is "reforming" its regulatory structure, recognizing that it was inadequate to the task in the present meltdown.

[17] http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf