

Implementation of Title VII of the Wall Street Reform and Consumer Protection Act

Testimony  
of  
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**BRIEF BIOGRAPHY**

After 25 years in private legal practice, Michael Greenberger served under Chairperson Brooksley Born as the Director of the Division of Trading and Markets (“T&M”) at the Commodity Futures Trading Commission (“CFTC”) from September 1997 to September 1999. In that capacity, he supervised approximately 135 CFTC personnel in CFTC offices in DC, New York, Chicago, and Minneapolis. During his tenure at the CFTC, he worked extensively on, *inter alia*, regulatory issues concerning exchange traded energy derivatives, the legal status of over-the-counter (“OTC”) energy derivatives, and the CFTC’s authorization of trading foreign exchange derivative products on computer terminals in the United States.

Professor Greenberger was also actively involved in the drafting of the May 7, 1998 CFTC “Concept Release on OTC Derivatives,” which, before being blocked by Congress with the support of the remaining members of the President’s Working Group on Financial Markets (“PWG”), was designed to encourage a public discussion on whether these multi-trillion dollar unregulated instruments should be subject to the kind of market regulation which has long governed – and continues to govern – the Nation’s equity and futures markets and which is embodied in Title VII of the Dodd-Frank Act.

While at the CFTC, Professor Greenberger also served on the Steering Committee of the PWG. In that capacity, he drafted portions of the April 1999 PWG Report entitled “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management.” The report enumerated regulatory recommendations to Congress in the wake of the near collapse of the Long Term Capital Management (“LTCM”) hedge fund. Further, as a member of the International Organization of Securities Commissions’ (“IOSCO”) Hedge Fund Task Force, he participated in the drafting of the November 1999 report of IOSCO’s Technical Committee relating to the LTCM episode: “Hedge Funds and Other Highly Leveraged Institutions.”

After a two-year stint between 1999 and 2001 as the Principal Deputy Associate Attorney General in the U.S. Department of Justice, Greenberger began his service as a Professor at the University of Maryland School of Law. At the law school, he has continued to focus on OTC derivatives. He currently teaches a course entitled “Futures, Options, and Derivatives.”

Professor Greenberger served in 2009 as the Technical Advisor to the United Nations Commission of Experts on Reforms of the International Monetary and Financial System and in 2009-2010 as a member of the International Energy Forum's Independent Expert Group on reducing worldwide energy price volatility.

During Congress’ consideration of the Dodd-Frank legislation, Professor Greenberger served as a volunteer technical advisor to Americans for Financial Reform and the Commodities Market Oversight Coalition, and he is now working with those groups on the implementation of the Dodd-Frank Act. To date, he has filed comments on 15 Dodd-Frank proposed rules.

Professor Greenberger is also the Founder and Director of the University of Maryland Center for Health and Homeland Security, an academic consulting center of nearly 65 professionals working at the local, state, federal, and international level providing legal and operational guidance on crisis management.

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## Introduction

*The Relationship of Unregulated OTC Derivatives to the Meltdown.* It is now accepted wisdom that it was the non-transparent, poorly capitalized, and almost wholly unregulated over-the-counter (“OTC”) derivatives market that lit the fuse that exploded the highly vulnerable worldwide economy in the fall of 2008.<sup>1</sup> Because tens of trillions of dollars of these financial products were pegged to the economic performance of an overheated and highly inflated housing market, the sudden collapse of that market triggered under-capitalized or non-capitalized OTC derivative guarantees of the subprime housing investments. Moreover, the many undercapitalized insurers of that collapsing market had other multi-trillion dollar OTC derivatives obligations with thousands of financial counterparties (through unregulated interest rate, currency, foreign exchange, and energy derivatives). If a financial institution failed because it could not pay off some of these obligations, trillions of dollars of interconnected transactions would have also failed, causing a cascade of collapsing banks throughout the world. It was this potential of systemic failure that required the United States taxpayer to plug the huge capital hole that a daisy chain of nonpayments by the world’s largest financial institutions would have caused, thereby heading off the cratering of the world’s economy.<sup>2</sup>

*An Example of the Multi-Trillion Dollar Derivative “Bets” That Had to Be Paid by the U.S. Taxpayer.* The then perfectly lawful “bets” that hedge fund manager John Paulson placed through this unregulated OTC derivatives market provide but a single example of how that market collectively misfired and – but for taxpayer bailouts – nearly imploded the world economy.<sup>3</sup> From 2006 to 2007, Mr. Paulson with, *inter alia*, the assistance of swaps dealers,

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<sup>1</sup> See Ben Moshinsky, *Stiglitz says Banks Should Be Banned From CDS Trading*, BLOOMBERG.COM (Oct. 12, 2009), <http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=a65VXsI.90hs>; Paul Krugman, Op-Ed, *Looters in Loafers*, N.Y. TIMES, Apr. 18, 2010, available at <http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk>. See generally Alan S. Blinder, *The Two Issues to Watch on Financial Reform — We Need an Independent Consumer Watchdog and Strong Derivatives Regulation. Industry Lobbyists are Trying to Water Them Down*, WALL ST. J., Apr. 22, 2010, available at <http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html>; Henry T. C. Hu, “Empty Creditors and the Crisis”, WALL ST. J., Apr. 10, 2009, at A13; MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010) [hereinafter *THE BIG SHORT*]; SIMON JOHNSON & JAMES KWAK, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN* (2011) [hereinafter *13 BANKERS*]; MICHAEL HIRSH, *CAPITAL OFFENSE: HOW WASHINGTON’S WISE MEN TURNED AMERICA’S FUTURE OVER TO WALL STREET* (2010) [hereinafter *CAPITAL OFFENSE*]; BETHANY MCLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS* (2010) [hereinafter *ALL THE DEVILS ARE HERE*]; *INSIDE JOB* (Sony Pictures Classics & Representational Pictures 2010); *Frontline: The Warning* (PBS television broadcast Oct. 20, 2009) [hereinafter *The Warning*]; FINANCIAL CRISIS INQUIRY COMMISSION, *THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES* xxiv (Jan. 2011), available at <http://www.fcic.gov/report> [hereinafter *FCIC REPORT*].

<sup>2</sup> See Moshinsky, *supra* note 1; Krugman, *supra* note 1; Blinder, *supra* note 1; Hu, *supra* note 1; *THE BIG SHORT*, *supra* note 1.

<sup>3</sup> Complaint at 2, *Securities and Exchange Commission v. Goldman Sachs & Co. and Fabrice Tourre*, 2010 U.S. Dist. Ct. 3229 (S.D.N.Y. Apr. 16, 2010) (“Undisclosed in the marketing materials and unbeknownst to investors, a large hedge fund, Paulson & Co. Inc. (‘Paulson’), with economic interests directly adverse to investors in the ABACUS 2007-AC1 CDO, played a significant role in the portfolio selection process. After participating in the selection of the reference portfolio, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps (‘CDS’) with [Goldman] to buy protection on specific layers of the ABACUS 2007-AC1 capital structure. Given its financial short interest, Paulson had an economic incentive to choose RMBS that it expected to experience credit events in the near future.”) (On July 15, 2010, Goldman Sachs entered into a settlement without admitting or denying the SEC’s allegations for the amount of \$550 million.)

purchased synthetic collateralized debt obligations (“CDOs”), which were nothing more than the purchase of insurance on his selection of weak tranches of subprime residential mortgage-backed securities that Mr. Paulson himself did not own.<sup>4</sup> In other words, through so-called “naked credit default swaps (‘CDS’),” Mr. Paulson effectively bought insurance on his own selection of subprime investments in which he had no ownership and for which he had no risk, but which he believed would fail. Since the dawn of the 19<sup>th</sup> century, it has not been legal to buy insurance on someone else’s risk. However, because these “bets” were categorized as OTC derivatives, they were expressly deregulated as “swaps” by Congressional enactment, and insurance laws were not applied.

When subprime mortgage borrowers (*i.e.*, those with various degrees of non-creditworthiness) defaulted and could not, as common sense would have suggested, sustain their mortgages, the tranches that Mr. Paulson insured (but did not own) failed, thereby triggering highly lucrative payment obligations to Mr. Paulson pursuant to his synthetic CDOs and naked CDS. Paulson ultimately made about \$15 billion on these bets.<sup>5</sup>

Even though the purchasers of synthetic CDOs, such as Mr. Paulson, “profited spectacularly from the housing crisis . . . they were not purchasing insurance against anything they owned. Instead, they merely made side bets on the risks undertaken by others.”<sup>6</sup> In fact, because synthetic CDOs mimicked insurance, those who were “insured” through synthetic CDOs were only required to sustain their multi- trillion dollar bets with insurance-like “premiums,” *i.e.*, they were only required to pay about two percent of the total amount insured.<sup>7</sup>

Moreover, as has been widely demonstrated, investors “creating” their synthetic bets that the subprime market would fail often repeatedly insured against the *same* weak subprime tranches, *i.e.*, many weak subprime tranches were “bet” to fail multiple times.<sup>8</sup> In essence, therefore, once a borrower defaulted on a mortgage, the loss in the real economy was exponentially multiplied by the many side bets placed on whether that borrower would default.

Mr. Paulson’s investments are reflective of trillions of dollars bet on the subprime market, and the astronomical amounts owed to the holders of this unregulated “insurance” of the subprime market serve as a microcosm of the worldwide financial crisis.<sup>9</sup>

Most importantly, the “insurers” of the subprime market (some of the most prominent financial institutions in the world) were not required to have capital to sustain their insurance or to post collateral to ensure their payments. (Had these investments been governed by insurance or gaming laws, those betting that subprime mortgages would be paid would have been required to have adequate capital to ensure payments if the bet were lost.) And, when the “insurers” were “surprised” to find that those without creditworthiness could not pay their mortgages, they did not have the ability to pay off their indebtedness to the holders of synthetic CDOs. However,

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<sup>4</sup> *Id.*

<sup>5</sup> Svea Herbst-Bayliss and Kevin Lim, *Paulson reassures on Goldman role*, REUTERS (April 21, 2010), available at <http://www.reuters.com/article/2010/04/21/us-goldman-paulson-redemptions-idUSTRE63K0C620100421?pageNumber=1>.

<sup>6</sup> FCIC REPORT, *supra* note 1, at 195.

<sup>7</sup> See THE BIG SHORT, *supra* note 1, at 51.

<sup>8</sup> See *id.*

<sup>9</sup> See generally THE BIG SHORT, *supra* note 1; see also INSIDE JOB, *supra* note 1.

what should have been a zero-sum game was converted from a lose-lose game into a win-win situation, *i.e.*, the Mr. Paulsons of this world only got paid because “insurers” were subsidized by the taxpayer so that the “casinos” could make payment on the bets. Unlike regular gambling, no gambler lost – except the perfectly innocent bystanders: the U.S. taxpayer.<sup>10</sup>

As it now stands, the world is attempting to dig itself out of the worst financial crisis since the Great Depression of the 1930’s – a task now aggravated, *inter alia*, by the burden of escalating energy and food commodity prices. As will be shown below, dozens of studies suggest that even those escalating commodity prices may very well be aided by betting on the upward direction of those prices through passive investments originated by U.S. financial institutions using unregulated OTC derivatives.<sup>11</sup>

*Dodd-Frank Provides the Tools to Protect the U.S. Taxpayer.* As will be shown below, Title VII of the Dodd-Frank Act, thanks to the major contribution of this Committee, would make it very difficult to repeat the kind of undercapitalized, non-transparent, and economy-busting “betting” mentioned above. That statute, *if properly implemented*, (1) requires all major players to have adequate capital to enter the market to sustain their potentially huge obligations; (2) requires that almost all of these kinds of investments be collateralized by counterparties; (3) requires almost all of these investments to be guaranteed and properly margined by clearing facilities, which, in turn, are subject to strict federal regulation and oversight; (4) requires all of these transactions to be publicly recorded and, in many instances, traded on public exchanges or exchange-like environments; and (5) collectively places the CFTC, the SEC, and the members of the Financial Stability Oversight Council in a position to have full transparency of these kinds of investments with an eye to preventing the kind of systemic risk that threatened the world economy in the fall of 2008.

*We Are Not Home Free Yet.* As will be shown below, there is now a substantial question whether Title VII of Dodd-Frank will be properly implemented because of resistance by big banks and other financial institutions. According to the Comptroller of the Currency, five big Wall Street banks have controlled 98% of the existing (pre-Dodd-Frank) OTC derivatives market, thereby necessitating, for example, the Antitrust Division of the Department of Justice to intervene in one of the critically important CFTC and SEC proposed rulemakings concerning ownership of the major new financial institutions created by Dodd-Frank. The big banks want to keep these institutions within their control. Needless to say, if properly implemented, the huge profits of these and other banks will be diminished by the competition that a transparent market brings, in the words of Dodd-Frank, “free and open access” to what would be highly competitive derivatives markets.

While each argument advanced by swaps dealers must be analyzed on its own merits, there can be no mistake that a fundamental underlying tenet of minimizing the impact of Dodd-Frank, either implicitly or explicitly, is that we are now out of the financial crisis and there is no need for change. Therefore, it is suggested that as much of the status quo ante as can be

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<sup>10</sup> See THE BIG SHORT, *supra* note at 1, at 256.

<sup>11</sup> Commodity Markets Oversight Coalition, EVIDENCE OF THE IMPACT OF COMMODITY SPECULATION BY ACADEMICS, ANALYSTS AND PUBLIC INSTITUTIONS (2011), <http://www.nefiactioncenter.com/PDF/evidenceonimpactofcommodityspeculation.pdf>.

preserved should now be left in place. A subsidiary argument is that if Dodd-Frank is fully enforced, it will be a job killer.

As shown above, the undercapitalized casino that unregulated derivatives fostered in the subprime housing market was the ultimate job and pension killer. The misery created by that unregulated market often gets lost in Wall Street talking points. Moreover, the economic infrastructure built before Dodd-Frank around subprime mortgages exists, *e.g.*, for prime mortgages, commercial mortgages, student loans, auto and credit card debt.

We are presently in a jobless “recovery.” Moreover, the shock of rapidly escalating energy and food prices, as well as threatened defaults by municipalities and European Union sovereign states, can either individually or collectively create economic dislocations akin to that experienced in the fall of 2008. For example, there is almost certainly an untold number of grossly undercapitalized naked CDS on municipal and sovereign obligations. If there are widespread defaults in those areas, an untold number of “insurance” guarantees will be triggered.

The loss of profits of “too big to fail” financial institutions, which have fully recovered and may be stronger now than before the meltdown, must be balanced against the well being of the American consumer, worker and taxpayer. Rejecting Dodd-Frank on the assumption that all is now well is a dangerous strategy to follow legislatively or at the regulatory level.

Whatever new costs Dodd-Frank imposes (and those costs are greatly exaggerated by those seeking to deflate regulation) are minimal compared to the dire economic havoc that might be caused by under-regulation, especially when Congress is now almost devoid of “stimulus bullets” to repair future economic ills.

*Funding for the CFTC and SEC.* Severely hampering the CFTC’s and SEC’s ability to implement Title VII of Dodd-Frank are their challenging financial and staffing conditions. I recognize that this Committee can only serve an authorization – not appropriation – role. It also only has jurisdiction over the CFTC. Nevertheless, the voice of this Committee on funding by appropriators for the CFTC can doubtless play an important role in ensuring proper implementation of Dodd-Frank.

With regard to the CFTC, that agency’s gross underfunding makes performing its new and complex functions under Dodd-Frank “a herculean task.”<sup>12</sup> Under the new regulations, the CFTC must examine a voluminous amount of data and information encompassing transactions that number in the millions.<sup>13</sup> An \$11 million slash in the technology budget has forced the agency to cease developing a new program that would scan the overwhelming number of trades to detect suspicious trading. Moreover, the potential long-term effects of insufficient funding is severe; operating under its current budget will mean that applications, findings, and enforcement required by the new law would languish.<sup>14</sup> As Commissioner Bart Chilton aptly warns, “Without

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<sup>12</sup> Ben Protess, *Regulators Decry Proposed Cuts in C.F.T.C. Budget*, N.Y. TIMES (February 24, 2011) (quoting CFTC Commissioner Michael Dunn), available at <http://dealbook.nytimes.com/2011/02/24/regulators-decry-proposed-c-f-t-c-budget-cuts/?ref=todayspaper>.

<sup>13</sup> Jean Eaglesham and Victoria McGrane, *Budget Rift Hinders CFTC*, WALL ST. J. (Feb. 25, 2011).

<sup>14</sup> See Transcript of the Congressional Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act before the H. Comm. on Agriculture (Feb. 15, 2011) (statement of Terry Duffy, Executive Chairman, CEM Group).

the funding, we could once again risk another calamitous disintegration.”<sup>15</sup> Lack of funds not only shortchanges the Commission, but it also risks another widespread financial crisis.

In this regard, the CFTC lacks an adequate number of personnel to perform its increased regulatory duties. From 1999 to 2007, the agency shrunk from 567 full-time equivalents (“FTEs”) to 437. By 2010, the number of FTEs had risen to 650, only a 30% increase in the number of personnel since the agency’s establishment in 1975. Chairman Gary Gensler estimates that he needs an additional 400 people to meet the challenges of regulating the multi-trillion dollar derivatives markets.<sup>16</sup> As Barbara Roper of the Consumer Federation of America has noted, for example, the “draconian cuts” of the House of Representatives’ proposed budget would “decimate that tiny agency without making any meaningful inroads in the federal deficit.”<sup>17</sup> Even the relatively fiscally conservative *Financial Times* has within this last week editorialized that the SEC and CFTC deserve the funding levels that were promised to prevent a future meltdown through proper implementation of Dodd-Frank.

It is one thing to attack Dodd-Frank frontally by seeking deregulatory action either through legislation or weakened rules. There can be little doubt, however, that starving financial regulatory agencies dependent upon appropriations is a *de facto* rescission of Dodd-Frank. It asks Americans to face yet another crisis under the guise of budget cuts – a crisis that may “the next time” drag the United States and the world into the next Great Depression.

In making this point, I also want to commend the CFTC for its heroic work in meeting the necessarily rigorous deadlines imposed by Dodd-Frank for well over 60 new rules. I spent 25 years in a private law practice heavily devoted to rulemaking advocacy, and then involvement in the judicial review of those rules in virtually every federal circuit court of appeals in the country and in the United States Supreme Court. I was also very proud of the many rules that were promulgated by the CFTC while I was the Director of the Division of Trading and Markets. However, the hard and productive work performed by the CFTC in implementing Dodd-Frank, especially with its small staff, is extraordinary. The quality of that work also meets the highest standards of public service. This Committee should be very proud of this effort. The agency has more than demonstrated that it will be a vigilant protector of the important markets it now oversees if it receives the financial support it needs from this Congress.

This testimony will highlight the manner in which the lack of regulation of the OTC derivatives market was a principal cause of the 2008 credit crisis and the resulting onset of the Great Recession and how Title VII of the Dodd-Frank Act, *if properly implemented*, can avoid similar crises in the future. The remainder of this testimony is based principally on my soon to be published article in the University of Maryland School of Law’s *Journal of Business and*

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<sup>15</sup> See Statement of Bart Chilton, Commissioner, Commodity Futures Trading Commission, Risky Business (February 24, 2011), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement022411.html>.

<sup>16</sup> Ben Protess and Mac William Bishop, *At Center of Derivatives Debate, a Gung-Ho Regulator*, N.Y. TIMES (Feb. 10, 2011), *available at* <http://dealbook.nytimes.com/2011/02/10/at-center-of-debate-over-derivatives-a-gung-ho-regulator/>.

<sup>17</sup> See Statement of Barbara Roper, Director of Investment Protection, Consumer Federation of America, Feb. 14, 2011.



*Technology Law*, as well as on a series of my previously published articles and testimony delivered to Congress and to the Financial Crisis Inquiry Commission.<sup>18</sup>

### **The Commodity Futures Modernization Act of 2000's Deregulation of Swaps**

On December 15, 2000, Congress passed the Commodity Futures Modernization Act of 2000 ("CFMA"), which President Clinton signed into law on December 21, 2000.<sup>19</sup> The CFMA removed OTC derivatives transactions, including energy futures transactions, from all requirements of exchange trading and clearing under the CEA so long as the counterparties to the swap were "eligible contract participants."<sup>20</sup> Generally speaking, a counterparty to be an "eligible contract participant" had to have in excess of \$10 million in total assets with some limited exceptions allowing lesser amounts in the case of an individual using the swap for risk management purposes.<sup>21</sup>

Thus, the OTC derivatives market (at that time according to then-Treasury Secretary Summers amounting to \$80 trillion notional value) was exempt from the traditional and time-tested regulatory controls of the securities and futures markets: capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation<sup>22</sup> and excessive speculation; and requirements for clearing. The SEC was similarly

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<sup>18</sup> This testimony article draws significantly from *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by An Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. Bus. & Tech. L. 127 (forthcoming 2011), available at [http://works.bepress.com/michael\\_greenberger/41/](http://works.bepress.com/michael_greenberger/41/), as well as the following previous publications and written testimony: *Derivatives in the Crisis and Financial Reform*, in THE POLITICAL ECONOMY OF FINANCIAL CRISES, OXFORD UNIVERSITY PRESS HANDBOOK (Gerald Epstein & Martin Wolfson eds., forthcoming 2011); *Is Our Economy Safe? A Proposal for Assessing the Success of Swaps Regulation under the Dodd-Frank Act*, in THE FUTURE OF FINANCIAL REFORM: WILL IT WORK? HOW WILL WE KNOW? (Roosevelt Institute 2010), available at [http://works.bepress.com/michael\\_greenberger/34/](http://works.bepress.com/michael_greenberger/34/); *Out of the Black Hole: Regulatory Reform of the Over-the-Counter Derivatives Market*, in MAKE MARKETS BE MARKETS 99 (Roosevelt Institute 2010), available at [http://works.bepress.com/michael\\_greenberger/35/](http://works.bepress.com/michael_greenberger/35/); *Out of the Black Hole: Reining in the Reckless Market in Over-the-Counter Derivatives*, AMERICAN PROSPECT (2010), available at [http://works.bepress.com/michael\\_greenberger/37/](http://works.bepress.com/michael_greenberger/37/); and Written Testimony of Michael Greenberger, *Hearing Before the Financial Crisis Inquiry Commission Regarding The Role of Derivatives in the Financial Crisis* (June 30, 2010), available at <http://www.fcic.gov/hearings/pdfs/2010-0630-Greenberger.pdf> [hereinafter FCIC Testimony].

<sup>19</sup> Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763.

<sup>20</sup> See FCIC Testimony, *supra* note 18, at 9.

<sup>21</sup> PHILLIP MC BRIDE JOHNSON AND THOMAS LEE HAZEN, DERIVATIVES REGULATION §1.02[3] 328-29 (Aspen 2004) [hereinafter DERIVATIVES REGULATION].

<sup>22</sup> Unlike financial swaps, which were "excluded" from the exchange trading requirement, including fraud and manipulation prohibitions, energy and metals swaps, while relieved of the exchange trading, continued to be subject to fraud and manipulation prohibitions; they were therefore labeled by the CFMA as "exempt" transactions. *Id.* Compare § 2(g) (relating to financial swaps) with § 2(h) relating to energy and metals swaps. *Id.* See also CHARLES W. EDWARDS ET. AL., COMMODITY FUTURES MODERNIZATION ACT OF 2000: LAW AND EXPLANATION 28 (2001) (quoting remarks of Sen. Tom Harkin, 146 Cong. Rec. S11896, December 15, 2000, "The Act continues the CFTC's antifraud and anti-manipulation authority with regard to exempt transaction in energy and metals derivative markets."). By exempting metals and energy swaps from exchange trading, Congress disagreed with the unanimous recommendation of the President's Working Group that swaps concerning "finite" supplies not be removed from the exchange trading mandate of the CEA. *Id.*

barred from OTC derivatives oversight except for the limited fraud jurisdiction it maintained over securities-based swaps.<sup>23</sup>

Recognizing that the deregulation of swaps would encourage widespread speculation through derivatives trading, *the CFMA also expressly preempted state gaming and anti-bucket shop laws*,<sup>24</sup> which would have barred the otherwise unregulated betting authorized by the CFMA.<sup>25</sup>

Years later, during the Troubled Asset Relief Program (“TARP”) hearings in September 2008, then-SEC Chairman Christopher Cox warned Congress about the need for “immediate legislative action,” because he viewed the OTC credit derivatives market as a “regulatory blackhole” based on the deregulatory provisions adopted within the CFMA.<sup>26</sup>

To address the problems presented by the unregulated OTC derivatives market, on July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)<sup>27</sup> into law. If properly implemented, the statute establishes a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity. Specifically, Dodd-Frank:

- provides for the registration and comprehensive regulation (including capital requirements and business conduct rules) of swap dealers and major swap participants;
- imposes collateral and trade execution requirements for most derivative products;
- imposes margin and capital requirements for all cleared swaps;
- creates recordkeeping and real-time reporting requirements; and
- enhances regulators’ ability to observe these markets, thereby enhancing enforcement activities for fraud and manipulation and assisting in preventing systemically risky practices.

### **The Economic Meltdown as a Failure of OTC Derivatives Regulation**

Although many factors contributed to the financial meltdown of 2008, principal among them was the collapse of the market in OTC derivatives. The OTC market in naked credit default swaps and synthetic collateralized debt obligations provided the trigger that launched the mortgage crisis, credit crisis, and systemic financial crisis that threatened to implode the global

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<sup>23</sup> See FCIC Testimony, *supra* note 18, at 10.

<sup>24</sup> See DERIVATIVES REGULATION at 975, *supra* note 21.

<sup>25</sup> *Id.*

<sup>26</sup> Robert O’Harrow, Jr. and Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1 (quoting former Chairman Christopher Cox, “The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting in the current credit crisis ... and it requires immediate legislative action.”).

<sup>27</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203.

financial system, were it not for a multi-trillion dollar U.S. taxpayer intervention.<sup>28</sup> At the time of the crisis, this OTC market was estimated to have a notional value of \$596 trillion, including approximately \$58 trillion in CDSs,<sup>29</sup> yet federal regulators (and most state regulators) were barred by a federal statute from ensuring stability in these transactions.<sup>30</sup> Before explaining below the manner in which naked credit default swaps (sometimes referred to as synthetic collateralized debt obligations) fomented this crisis, it is worth citing in the margin those many economists,<sup>31</sup> regulators,<sup>32</sup> market observers,<sup>33</sup> and financial columnists<sup>34</sup> who have described the central role unregulated CDS and synthetic CDOs played in the crisis.<sup>35</sup>

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<sup>28</sup> See generally Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 5, 2008, at B0; Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A0; Jon Hilsenrath et al., *Worst Crisis Since '30s, With no End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1; Testimony of Dr. Alan Greenspan, *The Financial Crisis and the Role of Federal Regulators: Hearing before the Committee on Oversight and Government Reform*, 111th Cong. (Oct. 23, 2008), available at <http://clipsandcomment.com/wp-content/uploads/2008/10/greenspan-testimony-20081023.pdf>.

<sup>29</sup> Naohiko Babo and Paola Gallardo, *OTC Market Activity in the Second Half of 2007*, BANK FOR INTERNATIONAL SETTLEMENTS (May 2008), available at [http://www.bis.org/publ/otc\\_hy0805.pdf](http://www.bis.org/publ/otc_hy0805.pdf).

<sup>30</sup> Michael Greenberger, *Is Our Economy Safe? A Proposal for Addressing the Success of Swaps Regulation*, in WILL IT WORK? HOW WILL WE KNOW? THE FUTURE OF FINANCIAL REFORM 37 (Michael Konczal ed., Roosevelt Institute 2010) [hereinafter Greenberger].

<sup>31</sup> See Moshinsky, *supra* note 1; Blinder, *supra* note 1; Hu, *supra* note 1; Krugman, *supra* note 1; THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; INSIDE JOB, *supra* note 1; James K. Galbraith, Statement before the Subcommittee on Crime Senate Judiciary Committee (May 4, 2010), available at <http://utip.gov.utexas.edu/Flyers/GalbraithMay4SubCommCrimeRV.pdf>.

<sup>32</sup> Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 24, 2008; Anthony Faiola et al., *What Went Wrong*, WASH. POST, Oct. 15, 2008; Peter S. Goodman, *Taking Hard New Look at the Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008; *Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing before the House of Representatives Committee on Agriculture*, 110th Cong. (Nov. 20, 2008) available at <http://www.ins.state.ny.us/speeches/pdf/sp0811201.pdf> (prepared testimony of Eric Dinallo, Superintendent, New York State Insurance Dept); Gary Gensler, Remarks at OTC Derivatives Reform, Chatham House, London (Mar. 18, 2010) (stating that “OTC derivatives were at the center of the 2008 financial crisis” and “Capital requirements should take into account the unique risks that credit default swaps (CDS) pose”); Testimony of Alan Greenspan, *supra* note 28; Greg Robb, *Roots of Credit Crisis Laid at Fed's Door*, MARKET WATCH (Oct. 24, 2007), available at <http://www.marketwatch.com/story/roots-of-credit-crisis-found-at-the-feds-door-says-expert>; THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; Inside Job, *supra* note 1.

CDSs were the last step in a subprime securitization process that came to undermine the economy.<sup>36</sup> A counterparty investing in a CDS paid, at most, about a 2% “premium” to another counterparty for the latter to agree to “guarantee” that the weakest parts of a financial instrument, a collateralized debt obligation (“CDO”), would not fail.<sup>37</sup> Thus, a CDS can be seen as a form of insurance on the success of specified tranches of a CDO.<sup>38</sup> CDOs, in turn, involved the “pulling together and dissection into ‘tranches’ of huge numbers of [mortgage-backed securities

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<sup>33</sup> See INVESTOR’S WORKING GROUP, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS’ PERSPECTIVE 1 (July 2009), available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%20Working%20Group%20Report%20(July%202009).pdf) (listing the fundamental flaws of the U.S. financial services sector exposed by the credit crisis: “. . . gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both ‘too big to fail’ and too labyrinthine to regulate or manage effectively”); Jonathan Berr, *George Soros wants to outlaw credit default swaps*, DAILYFINANCE (June 12, 2009), available at <http://www.dailyfinance.com/story/george-soros-wants-to-outlaw-credit-default-swaps/19065423/#> (“Credit default swaps, insurance contracts on securities in the event of a default, are widely blamed as one of the causes of the current financial crisis. The unregulated, \$70 trillion market became unhinged when the real estate market, particularly houses funded through subprime mortgages, collapsed.”); Henny Sender, *Greenlight Capital founder[David Einhorn] calls for CDS ban*, FINANCIAL TIMES, Nov. 6, 2009 (quoting Greenlight Capital founder David Einhorn: “. . . trying to make safer credit default swaps is like trying to make safer asbestos . . . [as CDSs create] large, correlated and asymmetrical risks”) available at <http://www.ft.com/cms/s/0/6b1945e6-caf9-11de-97e0-00144feabdc0.html>; Janet Tavakoli, *Washington Must Ban U.S. Credit Derivatives as Traders Demand Gold (Part One)*, HUFFINGTON POST, March 8, 2010, available at [http://www.huffingtonpost.com/janet-tavakoli/washington-must-ban-us-cr\\_b\\_489778.html](http://www.huffingtonpost.com/janet-tavakoli/washington-must-ban-us-cr_b_489778.html) (“Congress should act immediately to abolish credit default swaps on the United States, because these derivatives will foment distortions in global currencies and gold.”); THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; INSIDE JOB, *supra* note 1.

<sup>34</sup> See LAWRENCE G. McDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (CROWN BUSINESS, 2009); Robert Johnson, *Credible Resolution – What It Takes to End Too Big to Fail*, in ROOSEVELT INSTITUTE: MAKE MARKETS BE MARKETS 117–133 (2009) (“The recent crisis in the U.S. centered on the collapse of the housing bubble and the role of leverage, off balance sheet exposures, and complex OTC derivatives.”); Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 5, 2008 (“Policy makers have been unnerved by the rise of the [CDS] market because they are worried that sellers of protection may not have enough reserves to pay future claims and that default by one party could lead to a cascade of failures throughout the financial system.”); Jon Hilsenrath, et al., *Worst Crisis Since ’30s, With No End Yet In Sight*, WALL ST. J., Sept. 18, 2008, at A1 (“The latest trouble spot [in the financial crisis] is an area called credit-default swaps . . .”); Jeff Madrick, *At the Heart of the Crash*, NY REVIEW OF BOOKS, (June 10, 2010) (reviewing MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010)), available at <http://www.nybooks.com/articles/archives/2010/jun/10/heart-crash/?pagination=false> (“As we now know, derivatives were the instruments that enabled Wall Street to stretch capital dangerously far – and were at the center of the financial crisis that began that year.”); Gretchen Morgenson, *Naked Came the Speculators*, N.Y. TIMES, Aug. 10, 2008, (“As the sheriffs begin to confront the C.D.S. cowboys, more losses are bound to show up in this Wild West.”); THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; INSIDE JOB, *supra* note 1.

<sup>35</sup> See *infra* notes 139, 140, and 142.

<sup>36</sup> Michael Greenberger, *Out of the Black Hole: Regulatory Reform of the Over-the-Counter Derivatives Market*, in ROOSEVELT INSTITUTE: MAKE MARKETS BE MARKETS 99, at 100–02 (2010), available at <http://www.michaelgreenberger.com/files/Greenberger-Derivatives-MMBM.pdf>.

<sup>37</sup> *Id.* at 100.

<sup>38</sup> *Id.*

(‘MBSs’)],” based for their part on mortgage loans and, in the years before the crisis, subprime mortgages in particular.<sup>39</sup>

Importantly, by “reframing the form of risk (*e.g.*, from subprime mortgages to MBSs to CDOs),” those investors providing the guarantees of or insurance for the subprime market through CDSs lost sight of the fundamental transaction at issue, *i.e.*, whether noncreditworthy borrowers would pay home loans, and, because of the confusion caused by the reframing of risk, mistakenly thought that their investments were safe.<sup>40</sup> This problem was compounded by “misleadingly high evaluations” by credit rating agencies of those self-evidently weak tranches.<sup>41</sup> In addition, issuers of CDSs relied upon the faulty assumption that housing prices would never go down, so that they would never have to pay the guarantees they were providing.<sup>42</sup>

Because CDSs were widely understood to be risk-free, financial institutions began writing “naked” CDSs to investors who had no direct investment in or risk from CDOs or MBSs.<sup>43</sup> That is, investors bet with relatively small insurance-type premiums that certain handpicked mortgage-based instruments would fail, and that they would receive a hefty payment if they did.<sup>44</sup> Estimates suggest that before the crisis, there were almost certainly multiples of “naked” CDS to those based on insuring actual risk.<sup>45</sup>

All of this came to a head when housing prices began to plummet.<sup>46</sup> Homeowners began to default on loans, leading to the failure of CDOs and triggering obligations of CDS issuers.<sup>47</sup> Synthetic CDOs and naked CDSs added exponentially to the obligations owed, *i.e.*, the economy was not only confronted with real economic losses from the actual defaults, but from the multiplier effect of the betting losses on the wagers of whether those loans would be paid.<sup>48</sup>

This problem was especially insidious, because those who sold the guarantees believed that these provisions would never be triggered, issuers had not set aside sufficient capital to pay them off and therefore could not honor their contractual commitments.<sup>49</sup> In addition, because the investments were not reported to regulators, both the government and the financial community were surprised by the size of the market upon widespread defaults, which led to uncertainty and a tightening of credit.<sup>50</sup> Because the “bets” were private and unreported transactions, in a panic with failures of household financial institutions, the assumption was that all such institutions had or would have betting liabilities. All of these actual losses and fears of further losses resulted in the downward cycle of the economic meltdown, exacerbated by the fact that CDOs and CDSs existed not just in the subprime mortgage market, but in most credit markets.<sup>51</sup>

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<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at 101.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 102.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

The analysis surrounding this subject estimates that there may have been three to four times as many “naked” CDS instruments extant at the time of the meltdown than CDSs guaranteeing actual risk.<sup>52</sup> This means that to the extent the guarantor of a CDS (*e.g.*, AIG) had to be rescued by the U.S. taxpayer, the chances were very high that the “bail out” was of failed naked CDS bets that mortgages would be paid.<sup>53</sup> (Prominent members of Congress have maintained that the holders of bets that mortgages would fail have formed a strong political constituency against the “rescue” of subprime borrowers through the adjustment of mortgages to keep homeowners from defaulting).<sup>54</sup>

The fact that “naked” CDS and “synthetic” CDOs were nothing more than “bets” on the viability of the subprime market also demonstrates the importance of the CFMA expressly *preempting state gaming and anti-bucket shop laws*.<sup>55</sup> Had those laws not been preempted, it is almost certain that at least some states would have banned these investments as unlicensed gambling or illegal bucket shops.<sup>56</sup> An action of this sort by even a single state would have made the “naked” CDS market economically unviable throughout the country.<sup>57</sup>

Moreover, doubtless because Eric Dinallo, in his then capacity as New York Insurance Superintendent, seriously considered regulating CDS as insurance<sup>58</sup> and because the National Council of Insurance Legislators were working on a model code to regulate CDS as insurance,<sup>59</sup> Wall Street lobbyists ensured that the Dodd-Frank Act would also preempt state insurance law as it applies to swaps that are neither cleared or exchange traded.<sup>60</sup>

### **Dodd-Frank’s Solutions for Regulating Swaps**

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) into law.<sup>61</sup> Title VII of the Dodd-Frank Act

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<sup>52</sup> *Id.* at 101; *see also The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm.*, 110<sup>th</sup> Cong. at 3 (Oct. 14, 2008) available at <http://www.ins.state.ny.us/speeches/pdf/sp0810141.pdf> (prepared testimony of Eric Dinallo, Superintendent, New York State Insurance Dept.) (“... [I]t appears that swaps on that debt could total at least three times as much as the actual debt outstanding.”); Dawn Kopecki and Shannon D. Harrington, *Banning ‘Naked’ Default Swaps May Raise Corporate Funding Costs*, N.Y. TIMES (July 24, 2009), available at <http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk>.

<sup>53</sup> *See* Dinallo, *supra* note 52, at 3-4.

<sup>54</sup> *See* Ryan Grim, *Dick Durbin: Banks “Frankly Own The Place”*, HUFFINGTON POST, April 29, 2009, available at [http://www.huffingtonpost.com/2009/04/29/dick-durbin-banks-frankly\\_n\\_193010.html](http://www.huffingtonpost.com/2009/04/29/dick-durbin-banks-frankly_n_193010.html) (referring to rising number of Senate Democrats’ opposition to cram down).

<sup>55</sup> DERIVATIVES REGULATION, *supra* note 21 at 975 (referencing 7 U.S.C. § 16(e)(2)).

<sup>56</sup> *See* Dinallo, *supra* note 52, at 4-5.

<sup>57</sup> FCIC Testimony, *supra* note 18.

<sup>58</sup> Press Release, *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* (Nov. 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.”) [hereinafter Dinallo Press Release].

<sup>59</sup> *See* NATIONAL CONFERENCE OF INSURANCE LEGISLATORS, CREDIT DEFAULT INSURANCE MODEL LEGISLATION (Nov. 22, 2009), available at <http://www.ncoil.org/HomePage/2010/03212010CDIModel.pdf>.

<sup>60</sup> Restoring American Financial Stability Act of 2010, H.R. 4173, 111<sup>th</sup> Cong. § 722(b).

<sup>61</sup> Brady Dennis, *Obama Signs Financial Overhaul Into Law*, WASH. POST, July 22, 2010, at A13.

transforms the regulation of OTC derivatives by generally requiring that swaps be subject to clearing and exchange-like trading, including capital and margin requirements.<sup>62</sup>

The Act first requires that all “swap dealers” and “major swap participants” register with the appropriate banking regulators, the CFTC, and/or the SEC.<sup>63</sup> A swap dealer is an entity that (1) holds itself out as such, (2) makes a market in swaps, (3) regularly enters into swaps for its own account in the ordinary course of business, or (4) engages in activity generally recognized in the trade as dealing in swaps.<sup>64</sup> Major swap participants are entities that are not swap dealers and (1) maintain a substantial position in swaps, excluding transactions used to hedge commercial risk, (2) create substantial counterparty exposure that could undermine the banking system or financial markets, or (3) are highly leveraged, not subject to capital requirements, and maintain a substantial position in swaps.<sup>65</sup>

Registered swap dealers and major swap participants must disclose any material risks of swaps and any material incentives or conflicts of interests.<sup>66</sup> In addition, they must meet capital and margin requirements and conform to business conduct rules, including those related to fraud and market manipulation, that are set by the regulators (while clearing organizations and exchanges can supplement these requirements).<sup>67</sup> They must also conform to position limits on their trading volume in commodity swaps, which are to be set by the regulators.<sup>68</sup> The Dodd-Frank Act also requires that swaps transactions be reported.<sup>69</sup>

The Dodd-Frank Act imposes the clearing and exchange-like trading requirements on most swap transactions.<sup>70</sup> Both types of regulation are central features of the CEA’s regulation of futures.<sup>71</sup> Under a clearing system, a clearing facility stands between the buyer and seller of a contract to guarantee each against failure of the other party.<sup>72</sup> To avoid their own liability, clearing facilities have a strong incentive to establish and enforce the capital adequacy of traders, including the collection of margin, *i.e.*, deposits on the amount at risk in a trade.<sup>73</sup> Under the Dodd-Frank Act, the regulatory agencies decide whether specific types of swaps must be cleared, and designated clearing organizations (“DCOs”) must inform regulators about which types of swaps they plan to clear.<sup>74</sup> DCOs must allow “non-discriminatory” access to clearing.<sup>75</sup> Swaps

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<sup>62</sup> BAIRD WEBEL ET AL., CONG. RESEARCH SERV., R40975, FINANCIAL REGULATORY REFORM AND THE 111<sup>TH</sup> CONGRESS 12 (2010) *available at* [http://assets.opencrs.com/rpts/R40975\\_20100601.pdf](http://assets.opencrs.com/rpts/R40975_20100601.pdf) (“H.R. 4173 . . . mandate[s] reporting, centralized clearing, and exchange-trading of OTC derivatives . . . The bill[] require[s] regulators to impose capital requirements on swap dealers and ‘major swap participants.’”).

<sup>63</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731(a) (2010).

<sup>64</sup> *Id.* § 721(a).

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* §§ 731(h)(3)(B), 764(g)(3)(B)(i)–(ii).

<sup>67</sup> *Id.* §§ 731(e), 764(e)–(h).

<sup>68</sup> *Id.* §§ 737, 763(h).

<sup>69</sup> *Id.* § 727(c).

<sup>70</sup> *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65882 (Oct. 26, 2010) (explaining some of the regulations that the Dodd-Frank Act imposes on swap transactions).

<sup>71</sup> FCIC Testimony, *supra* note 18, at 99.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 723(h)(2)(A), 763(a)(1) (2010).

that are required to be cleared must also be traded on a designated contract market, securities exchange or swap execution facility (“SEF”).<sup>76</sup> Swaps do not have to be cleared or exchange traded if no existing entity lists a particular swap product.<sup>77</sup>

The Dodd-Frank Act contains an “end-user” exception to clearing designed to ease the burden on businesses using swaps to mitigate risk associated with their commercial activities.<sup>78</sup> For example, airlines buying fuel may use uncleared swaps to hedge against price increases. The exception applies to parties that are not financial entities, are using swaps to hedge or mitigate commercial risk, and have notified the CFTC and/or SEC as to how they meet financial obligations of non-cleared swaps.<sup>79</sup> It does not cover swaps in which both parties are major swap participants, swap dealers, or other financial entities.<sup>80</sup>

Despite the end-user exception, the Dodd-Frank Act imposes its reporting requirements for all swaps, whether or not they are cleared.<sup>81</sup> The swaps must be reported to a registered swap data repository, the CFTC or the SEC, and reporting must occur as soon as technologically possible after execution.<sup>82</sup> The Act’s sponsors and the regulators have now stated that margin requirements are not intended to apply to end-users.<sup>83</sup>

An important provision in the Dodd-Frank Act is the Lincoln or “Push-Out” Rule, which prohibits federal assistance to any bank operating as a swap dealer in most commodity-type derivatives transactions.<sup>84</sup> Federal assistance is defined broadly to include, *inter alia*, federal deposit insurance or access to the Federal Reserve’s discount window.<sup>85</sup> Although the Push-Out Rule does not take effect for two years, its logical consequence may be to encourage banks to “push out” or divest their commodity-based swap divisions, so that they can maintain access to federal banking resources.<sup>86</sup>

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<sup>75</sup> *Id.* § 763(a)(2)(B).

<sup>76</sup> *Id.* §§ 723(e), 763(a)(2)(B).

<sup>77</sup> *Id.* § 763.

<sup>78</sup> See Letter from Christopher Dodd, Chairman, Senate Committee on Banking, Housing, and Urban Affairs & Blanche Lincoln, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, to Barney Frank, Chairman, Financial Services Committee & Colin Peterson, Chairman, Committee on Agriculture, (June 30, 2010), available at [http://www.wilmerhale.com/files/upload/June%2030%202010%20Dodd\\_Lincoln\\_Letter.pdf](http://www.wilmerhale.com/files/upload/June%2030%202010%20Dodd_Lincoln_Letter.pdf) (explaining that the end-user exception is “for those entities that are using the swaps market to hedge or mitigate commercial risk.”).

<sup>79</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 723(h)(7), 763(g) (2010).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* §§ 727, 731, 764.

<sup>82</sup> *Id.* §§ 727, 729, 763, 764.

<sup>83</sup> *Id.* §§ 731, 764; See Clearly Gottlieb, *Dodd-Frank Wall Street Reform and Consumer Protection Act Poised to Usher in Sweeping Reform of U.S. Financial Services Regulation*, July 9, 2010, at 25, available at <http://www.cgsh.com/files/News/8a4361fa-131b-46b9-a3ad-779430dac8a6/Presentation/NewsAttachment/153327b9-3da0-4d63-b2cb-32c8022d8159/Clearly%20Gottlieb%20Dodd-Frank%20Alert%20Memo.pdf>

(“Recent correspondence between Senators Dodd and Lincoln states that the margin requirements are not intended to be interpreted to require end user counterparties to post margin to a swap dealer or major swap participant . . . [R]egulators and commentators will need to consider what weight, if any, to give to this legislative history.”).

<sup>84</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716 (2010).

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*



Similarly, the Volcker Rule generally prohibits banks from engaging in proprietary trading (that is, trading that is on its own behalf and not a customer's) or acquiring or retaining an interest in a hedge fund or private equity fund.<sup>87</sup> While the Volcker Rule will not be implemented immediately,<sup>88</sup> the consequence almost certainly is that many of these activities will also move from banks to other smaller and less systemically risky entities.<sup>89</sup>

Dodd-Frank also creates a resolution authority, which allows complicated questions of the orderly unwinding of a too-big-to-fail institution to be handled administratively rather than in a bankruptcy proceeding.<sup>90</sup> However, as one noted economist has recently made clear, the unwinding of the obligations of OTC counterparties may, in the absence of effective implementation of the Dodd-Frank OTC derivative reforms, be far too complex regardless of whether it is conducted by banking regulators or by a court.<sup>91</sup> Robert Johnson has concluded:

[W]hen a [too big to fail institution] is in trouble — and there are substantial holdings of complex and opaque derivatives on the balance sheets of all [such] firms — resolution authorities have difficulty unraveling web of exposures and valuing them properly. . . . Unfortunately, it is easy to understand why resolution authorities could be induced to forebear rather than resolve [an too big to fail institution] when they have no clarity about its structure and patterns of exposures. In such a circumstance, it may be easier to incur the risk that the insolvent [firm's] balance sheet should continue to deteriorate. . . .<sup>92</sup>

### **How Will We Know If the Dodd-Frank Act Is Working?**

Dodd-Frank has been hailed as an important and comprehensive financial reform.<sup>93</sup> But like many reforms before it, proof of its success lies not within the text of the law, but in how it is administratively implemented. Those questions of implementation are now hotly contested in SEC and CFTC rulemakings. In thinking about how those rulemakings will be carried out, it is worth asking, for example, what will that previously destabilizing market look like in five years? How will we know if the Act has successfully changed the landscape of the U.S. financial system? How will we know if taxpayers and consumers are better protected against another economic meltdown? If effectively implemented, OTC markets should ultimately have:

*1. Ninety per cent of standardized OTC derivatives being cleared and exchange traded, with just 10% exempt based on the end-user exclusion.*

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<sup>87</sup> *Id.* § 619.

<sup>88</sup> The Financial Stability Oversight Council will first conduct a six-month study, after which regulators will have nine months to write regulations; the provisions will take effect the earlier of 12 months after the agencies issue regulations or two years after enactment of Dodd-Frank, but banks will have a two-year transition period that can be extended up to three years. *Id.*

<sup>89</sup> Greenberger, *supra* note 30, at 38.

<sup>90</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 201–217 (2010).

<sup>91</sup> See Johnson, *supra* note 34, at 123.

<sup>92</sup> *Id.*

<sup>93</sup> See, e.g., Dennis, *supra* note 61 (“President Obama launched a new era in the relationship between Washington and the financial world when he placed his signature Wednesday on a massive bill to rewrite the nation's financial rules.”).

The basic rule of the Dodd-Frank Act is that swaps must be cleared and exchange traded. One of the few exceptions is for commercial end users.<sup>94</sup> As CFTC Chairman Gary Gensler has said, the “exception should be . . . defined to include only nonfinancial entities that use swaps as an *incidental part of their business* to hedge actual commercial risks. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system.”<sup>95</sup>

To achieve this end, regulators must carefully consider how they define hedging for commercial risk. A model for doing so may come from proposed CFTC position limit regulations promulgated in January 2010, which would have imposed potential speculative position limits on futures contracts for certain energy commodities.<sup>96</sup> Suggesting an exemption for bona fide hedging, the CFTC relied on a definition from regulation 1.3(z), under which bona fide hedging includes “transactions or positions [that] normally represent a substitute for transactions to be made or positions to be taken at a later time *in a physical marketing channel*, and where they are economically appropriate to the reduction of risks in the conduct and management of a *commercial enterprise*.”<sup>97</sup> Further, the CFTC emphasized that “[u]nder the proposed regulations, traders holding positions pursuant to a *bona fide* hedge exemption would generally be prohibited from also trading speculatively. This definition limits the end-user exemption to those whose intent is, ultimately, to purchase or sell a physical commodity, rather than a bank.”<sup>98</sup> Such an approach would be sufficiently narrow to limit financial entities from circumventing the central Dodd-Frank regulatory tenets: clearing and exchange-like trading.

*2. Swap dealers or major swap participants will have no more than 20% ownership of any derivative clearing organization (“DCO”), board of trade (“BOT”), or swap execution facility (“SEF”).*

One of the main principals shaping derivatives regulation under the Dodd-Frank Act is to provide free and open access to clearing and exchange trading by financial institutions.<sup>99</sup> Simply put, clearing and exchange trading are designed to reduce risk by providing price transparency, requiring that investors set aside adequate capital in case of default, and producing public

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<sup>94</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723(a)(7) (2010) (providing an exception to the clearing requirement for some non-financial entities); see also End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (proposed Dec. 23, 2010).

<sup>95</sup> Gary Gensler, Chair of the CFTC, Remarks at Exchequer Club of Washington, (Nov. 18, 2009), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-20.html> (emphasis added).

<sup>96</sup> See Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (proposed Jan. 26, 2010) (withdrawn 75 Fed. Reg. 50950 (Aug. 18, 2010)). The January 2010 proposal was withdrawn to accommodate a broader position limit proposal reflecting the expanded authority provided by the Dodd-Frank Act, but the substance as it relates to the text above is virtually identical. See Position Limits for Derivatives, 76 Fed. Reg. 4752, 4756 (proposed Jan. 26, 2011).

<sup>97</sup> See *id.*, at n. 49 (citing 17 CFR 1.3(z)(1)).

<sup>98</sup> See Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144, 4159 (Jan. 26 2010).

<sup>99</sup> See, e.g., S. REP. NO. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); CFTC & SEC, PUBLIC ROUNDTABLE ON GOVERNANCE AND CONFLICTS OF INTEREST IN THE CLEARING AND LISTING OF SWAPS 33 (Aug. 20, 2010), available at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission9\\_082010.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission9_082010.pdf) (statement of Randy Kroszner, University of Chicago, Booth School of Business) (“And the law is clear: Open access is the fundamental principle.”) [hereinafter CFTC/SEC Roundtable].

information on who is involved in trading and to what extent.<sup>100</sup> But if large numbers of trading institutions are excluded from clearing organizations or exchanges, the protections otherwise contributed by these requirements will be undermined.<sup>101</sup>

Already, large swap dealers and banks are working by lobbying and through the proposed rulemaking process to limit access by and competition from smaller entities by creating ways to exert large bank control over DCOs, BOTs, and SEFs.<sup>102</sup> According to the Office of the Comptroller of the Currency, *just five U.S. banks represent 98% of the total amount invested by banks in swaps.*<sup>103</sup> In many cases, clearinghouses and exchanges are dominated by very large financial institutions, including those that are the five dominant swaps dealers.<sup>104</sup> In an apparent attempt to discourage competition, the big banks, in their roles as clearinghouse owners, have imposed unnecessarily high capital requirements or other thresholds, far in excess of that needed for conservative risk management, as minimums for satisfying the clearinghouse membership eligibility, in order to keep smaller but highly credit worthy institutions out of the clearing process.<sup>105</sup>

While several proposals have been advanced, a simple solution to this problem is to curtail the influence and control of large banks over clearing and exchange institutions by capping their ownership at a maximum of 20%. Indeed, the CFTC proposed a rule that included imposing the 20% ownership limitations on October 1, 2010.<sup>106</sup> The 20% ownership restriction is similar to an amendment proposed in 2009 by Representative Stephen Lynch and included in the House version of the Dodd-Frank bill. This amendment would have restricted the beneficial ownership interest to an aggregate of 20% of all swap dealers and major swap participants, as well as those associated with them.<sup>107</sup> Although the Lynch amendment was removed from Dodd-Frank by the Conference Committee before final passage, the Dodd-Frank Act requires the CFTC and SEC to adopt rules eliminating conflicts of interest arising from the control of clearing and exchange institutions where a swap dealer or major swap participant has “a material

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<sup>100</sup> S. REP. NO. 111-176, at 29–35 (2010) (“The combination of these new regulatory tools will provide market participants and investors with more confidence during times of crisis, taxpayers with protection against the need to pay for mistakes made by companies, derivatives users with more price transparency and liquidity, and regulators with more information about the risks in the system.”).

<sup>101</sup> Greenberger, *supra* note 30, at 39.

<sup>102</sup> *Id.*

<sup>103</sup> COMPTROLLER OF THE CURRENCY, OCC’S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, FIRST QUARTER 2010, at Graph 4, *available at* <http://www.occ.treas.gov/ftp/release/2010-71a.pdf> [hereinafter OCC Report] (finding swaps transactions that involved banks outside the top five were just \$3,186 out of a total of \$136,330).

<sup>104</sup> *E.g.*, CFTC/SEC Roundtable, *supra* note 99, at 112 (statement of Michael Greenberger) (stating that one exchange’s ownership structure includes nine banks taking 50% of profits).

<sup>105</sup> *See id.* at 25–26, 39 (statements of Jason Kastner, Vice Chairman, Swaps and Derivatives Market Association) (stating that banks have been “really clever about keeping people out of the system” and providing example that one clearinghouse has set high capital requirements and large amounts of previously cleared swaps for institutions to join).

<sup>106</sup> Matthew Leising, *CFTC Proposes Capping Bank Stakes in Clearinghouses*, BLOOMBERG.COM (Oct. 1, 2010), *available at* <http://www.bloomberg.com/news/2010-10-01/cftc-proposes-20-bank-ownership-caps-on-swaps-clearinghouses.html>; *see* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732, 63733 (October 18, 2010).

<sup>107</sup> *See* H.R. REP. NO. 111-370, pt. 5, at 188 (2009).

debt or material equity investment.”<sup>108</sup> In carrying out the duties expressly delegated by the Act, the CFTC and SEC have complete and unfettered discretion to create restrictions on ownership—including aggregate numerical caps.<sup>109</sup> These restrictions would be effective and clear tools for ensuring that large banks would not employ highly anti-competitive policies over clearing and exchange institutions in a manner that would exclude smaller, but fully capitalized, participants.

Some observers have argued that requiring an independent board of governors—that is, one that is not comprised of banks, but outside experts or other members—would effectively avoid the problem of overly concentrated power.<sup>110</sup> However, a recent example shows the futility of relying on that approach alone: In 2009, ICE Trust acquired the Clearing Corp., creating a clearinghouse essentially owned by nine of the largest swap trading banks.<sup>111</sup> Although ICE Trust claims to be managed by an independent board, the acquisition involved a profit-sharing scheme in which these banks not only have an ownership in ICE Trust, but, in addition, will receive collectively in their own names 50% of the profits. The founding banks will be subject to a pricing structure distinct from that applied to other banks.<sup>112</sup> In order to mitigate the potential conflicts of interest in the operation of a DCO, DCM, and SEF, the CFTC and the SEC separately proposed rules to mandate more outside directors to serve on the board of a DCO, DCM and SEF.<sup>113</sup> However, when confronting the kind of massive concentration of

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<sup>108</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 726, 765. *See also* CONG. REC. 5217 (June 30, 2010) (in a colloquy with Rep. Lynch, House Financial Services Chair Barney Frank agreeing that Sections 726 and 765 of the Dodd-Frank Act require the SEC and CFTC to adopt rules eliminating the conflicts of interest arising from the control of clearing and trading facilities by entities such as swap dealers, security-based swap dealers, and major swap and security-based swap participants).

<sup>109</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 726, 265. *See, e.g.*, Matthew Leising, *CFTC May Limit Banks to 20% Stakes for Clearinghouses*, BLOOMBERG.COM (Sept. 30, 2010), available at <http://www.bloomberg.com/new/2010-09-29/cftc-said-to-propose-20-bank-ownership-of-swaps-clearinghouses.html> (“The Commodity Futures Trading Commission is considering limiting banks and investors to owning no more than 20 percent of swaps clearinghouses, exchanges and trading systems.”); *see also* Jonathan Spicer & Roberta Rampton, *CFTC Eyes Ownership Caps for Swaps Infrastructure*, REUTERS (Sept. 29, 2010), available at <http://www.reuters.com/article/idUSN2911906520100930>; *see also* CFTC/SEC Roundtable, *supra* note 99, at 112 (stating that the conflict of interest “provision is extraordinarily broad”); *see also* Comment Letter by Christine A. Varney, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, to David Stawick, Secretary, Commodity Futures Trading Commission, Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest (December 28, 2010), available at [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26809&SearchText=\(DOJ Antitrust Division strongly advises the CFTC to adopt a strict aggregate limit on ownership by swap dealers and major swap participants for DCOs, DCMs and SEFs\).](http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26809&SearchText=(DOJ%20Antitrust%20Division%20strongly%20advises%20the%20CFTC%20to%20adopt%20a%20strict%20aggregate%20limit%20on%20ownership%20by%20swap%20dealers%20and%20major%20swap%20participants%20for%20DCOs%20DCMs%20and%20SEFs))

<sup>110</sup> *See, e.g., id.* at 120–21 (statement of Lynn Martin, NYSE Life) (stating that board independence is a more effective way to handle conflicts of interest than mandating ownership restrictions, because it ensures broad representation of constituency interests).

<sup>111</sup> INTERCONTINENTAL EXCHANGE, ANNUAL REPORT 2 (2009), available at [https://materials.proxyvote.com/Approved/45865V/20100323/AR\\_56919/images/IntercontinentalExchange-AR2009.pdf](https://materials.proxyvote.com/Approved/45865V/20100323/AR_56919/images/IntercontinentalExchange-AR2009.pdf).

<sup>112</sup> *ICE Trust to Begin Processing and Clearing Credit Default Swaps March 9*, THE CLEARING CORP., March 6, 2009, available at <http://www.clearingcorp.com/press/pressreleases/20090306-ice-process-cds.html>.

<sup>113</sup> Rachele Younglai & Roberta Rampton, *FACTBOX-Differences in SEC, CFTC Clearinghouse Proposals*, REUTERS, Oct. 13, 2010, available at <http://www.reuters.com/article/idUSN1318594320101013>; *see* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732 (Oct. 18, 2010).

market power through the ownership of the strongest swaps dealers as is presently the case with ICE Trust, even the most demanding requirements for the inclusion of independent board directors, in and of themselves, can by no means realistically insure Dodd-Frank's "free and open access" mandate. There must be strict aggregate ownership limits to complement strong independent director requirements.

*3. All large financial institutions that deal in or buy swaps would be subject to strict capital requirements and rigorous business conduct rules.*

As noted above, swap dealers and major swap participants must conform to capital requirements and business conduct rules set by the regulators. As they define the term "swap dealers," regulators should aim to capture the top 200 or so entities dealing in derivatives.<sup>114</sup> As Chairman Gensler recently stated, "initial estimates are that there could be in excess of 200 entities that will seek to register as swap dealers [under the Dodd-Frank Act]," including "[209] global and regional banks currently known to offer swaps" as "Primary Members" of the International Swaps and Derivatives Association ("ISDA").<sup>115</sup> These entities should be encompassed by the definitions adopted by the CFTC and SEC.

To achieve this number, these agencies should consider how they define several terms. First, the CFTC and SEC should adopt a definition used by ISDA for deciding which institutions should be registered. The ISDA definition includes all business organizations and entities that deal in derivatives except those who do so "solely for the purposes of risk hedging or asset or liability management."<sup>116</sup> In adopting this definition, the regulators should also clarify that it does not exclude entities that claim to use derivatives for risk hedging or asset or liability management, but for whom the transactions could materially affect their financial condition based on the significant revenue generated by the swaps.

Another key issue will be how to determine whether a firm enters into swaps in the course of "regular business," because swap dealers do not include persons who enter into swaps for their own account, as long as they do not do so as part of their regular business.<sup>117</sup> To ensure that regulation will cover the largest dealers, regulators should define regular business based on an institution's annual average trading revenue from all swaps activities, as a percentage of total trading revenue. This percentage provides insight as to the nature of an institution's business, and agencies should use it to compare the relative positions of various institutions as well as the importance of swaps to a particular firm.<sup>118</sup>

Because trading revenue from swaps activities is currently unavailable to the public or regulators,<sup>119</sup> in order to allow regulators to assess this percentage, the regulators should require

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<sup>114</sup> Greenberger, *supra* note 30, at 40.

<sup>115</sup> Statement of Chairman Gary Gensler, ISDA Regional Conference (Sept. 16, 2010), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-50.html>.

<sup>116</sup> See Official Website of International Swaps and Derivatives Association, Inc., "Primary Membership," *available at* <http://www.isda.org>.

<sup>117</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721(a)(21) (2010); *see also* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80173 (proposed Dec. 21, 2010).

<sup>118</sup> Greenberger, *supra* note 30, at 40.

<sup>119</sup> *Id.*

all entities that have annual trading revenue over one billion dollars to provide the appropriate regulator with audited financial statements reporting gross and net trading revenue from all swap activities. The percentage triggering regulation should be two percent, and the percentage should be adjusted accordingly based on the reported data going forward.

The term “major swap participant” encompasses three broad categories: entities that maintain a substantial position in “major swaps categories,” those that pose substantial risk to counterparties, and those that are highly leveraged.<sup>120</sup>

Here, “major swaps categories” should be broken down to reflect relatively specific commodity products, so that entities that are heavily involved in a commodity—and thus can influence prices—do not escape regulation by “hiding” within a larger category. For example, the categories should be defined not just as “energy” or even “crude oil,” but should be broken down to a precise commodity product, *i.e.*, “light sweet crude oil.” In addition, “substantial position” should be measured by the notional value of an entity’s swap positions, as a proportion of the notional value of all swaps positions held by all entities. This illustrates how concentrated risk is, and regulators can use the information to ensure that the firms with the most risk are covered by regulation.

Entities creating substantial counterparty exposure can be determined by looking at two factors: (1) how much is currently at risk in case of default, measured by the market value of contracts, and (2) how much could potentially be at risk in the future over the life of the contract.<sup>121</sup> To assess both, agencies should consider how many counterparties are at risk through swaps transactions with a given entity—a measure of interconnectedness, or the extent to which an institution’s failure would have a ripple effect into the overall economy. In addition, agencies should consider the financial stability of counterparties to capture transactions that involve one or very few counterparties but may still create substantial risk.

Highly leveraged entities can be identified based on the entities’ current credit risk relative to their capital.<sup>122</sup> Where agencies find that entities have taken on too much risk, they should restrict them from additional swaps activities and/or require an increase in available capital. This will prevent an excessively leveraged firm from triggering significant market dysfunction.<sup>123</sup>

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<sup>120</sup> See *id.*; see also Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security- Based Swap Participant,” and “Eligible Contract Participant,” 75 Fed. Reg. 80173 (proposed Dec. 21, 2010).

<sup>121</sup> See PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 9 (April 1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>.

<sup>122</sup> See OCC Report, *supra* note 103, at 4 (“Net current credit exposure is the primary metric used by the OCC to evaluate credit risk in bank derivatives activities.”); see also Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security- Based Swap Participant,” and “Eligible Contract Participant,” 75 Fed. Reg. 80173, 80198 (proposed Dec. 21, 2010).

<sup>123</sup> See generally DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009).

4. *Proprietary and commodity trading, hedge and equity funds, and uncleared credit default swaps will be generally moved from large banks to smaller structures with fewer potential adverse impacts on the overall financial system.*

As noted earlier, the Dodd-Frank Act includes both the “Volcker Rule,” which generally prohibits banks from engaging in proprietary trading or ownership of hedge or equity funds, and the “Lincoln” or “Push-Out Rule,” which requires bank holding companies to establish separate affiliated corporations for, *inter alia*, most commodity swaps dealings and unregulated CDSs in order to benefit from federal assistance.<sup>124</sup> Although both provisions have long lead times before implementation, they are already having their intended effects.<sup>125</sup>

In anticipation of the Volcker Rule, for example, a private equity division at Bank of America left in the fall of 2010 to form a new hedge fund.<sup>126</sup> Even before the final bill was passed, Citigroup sold a private equity fund, and it is considering moving at least one of its proprietary trading units into a separate hedge fund.<sup>127</sup> At Goldman Sachs, proprietary traders are reportedly leaving to join new or existing hedge funds.<sup>128</sup> Moreover, Bloomberg reported that “Goldman Sachs during 2010 ‘liquidated substantially all of the positions’ in the principal-strategies unit that operated within the firm’s equities division.”<sup>129</sup> JP Morgan recently announced it will shut down its proprietary trading in commodities as a first step in closing down all proprietary trading.<sup>130</sup> All of these firms, and traders within them, have stated that they are taking action to resolve regulatory uncertainty, so that they are not “. . .worrying about what they’re going to be doing a couple of years from now. . . .”<sup>131</sup>

As Kansas City Federal Reserve President Hoening has recently made clear, this movement is healthy<sup>132</sup>—a sign that the Volcker and Lincoln Rules will have a powerful impact. The transactions covered by the Rule will move from banks that are too-big-to-fail to more diverse and less systemically risky parts of the market. As the Senate Committee on Banking suggested, the Volcker Rule “. . . will reduce the scale, complexity, and interconnectedness of

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<sup>124</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 619 and 716 (2010).

<sup>125</sup> Randall Smith et. al., *The New Rules of Finance: Impact to Reach Beyond Wall Street — Key Questions Unresolved for Businesses and Consumers Until Bill Goes Into Effect*, WALL ST. J., July 16, 2010, at A4.

<sup>126</sup> Martin Arnold & Francesco Guerrero, *Buy-out Spin-off Move by B of A*, FIN. TIMES (London), Aug. 4, 2010, at Companies – International 19.

<sup>127</sup> *Id.*; see also Dawn Kopecki & Chanyaporn Chanjaroen, *JPMorgan Said to End Proprietary Trading to Meet Volcker Rule*, BLOOMBERG NEWS (Aug. 31, 2010), available at <http://www.bloomberg.com/news/2010-08-31/jpmorgan-is-said-to-shut-proprietary-trading-to-comply-with-volcker-rule.html>.

<sup>128</sup> Christine Harper & Saijel Kishan, *Goldman Sachs Said to Shut Principal Strategies Unit*, BLOOMBERG NEWS (Sep. 4, 2010), <http://www.bloomberg.com/news/2010-09-03/goldman-said-to-shut-principal-strategies-unit-to-comply-with-volcker-rule.html>.

<sup>129</sup> See Christine Harper, *Goldman Sachs Liquidates 2 Proprietary Trading Units to Comply with Rules*, BLOOMBERG.COM (March 1, 2011), available at <http://www.bloomberg.com/news/2011-03-01/goldman-sachs-liquidates-2-proprietary-trading-units-to-comply-with-rules.html>.

<sup>130</sup> Kopecki & Chanjaroen, *supra* note 127.

<sup>131</sup> Harper & Kishan, *supra* note 128.

<sup>132</sup> See Thomas M. Hoening, President, Federal Reserve Bank of Kansas City, *Remarks at Women in Housing and Finance on Financial Reform: Post Crisis?* (Feb. 23, 2011), available at <http://www.kansascityfed.org/publicat/speeches/hoenig-DC-Women-Housing-Finance-2-23-11.pdf> (stating that “We must break up the largest banks, and could do so by expanding the Volcker Rule and significantly narrowing the scope of institutions that are now more powerful and more of a threat to our capitalist system than prior to the crisis.”).

those banks that are now actively engaged in proprietary trading, or have hedge fund or private equity exposure. [It] will reduce the possibility that banks will be too big or too complex to resolve in an orderly manner should they fail.”<sup>133</sup> In addition, investment banks will not be able to create risky financial products and sell them to investors, while holding on to the other side of the bets to make profits at customers’ expense.<sup>134</sup>

The Lincoln or Push-Out Rule is also already driving risky trades into more diverse structures.<sup>135</sup> JP Morgan, for example, is spinning off its high-risk commodity derivatives into a unit that will be separate from its other investments.<sup>136</sup> This movement is healthy, because speculation in commodity swaps has almost certainly contributed significantly to price volatility in commodities and commodity index funds, an effect that has increased with the influx of more speculation, including “the rapid growth of index investment” in commodity futures markets.<sup>137</sup> To the extent that smaller and more diverse entities engage in such speculation, they will have a lessened impact on commodity index fund prices, simply because they have less influence in these markets.<sup>138</sup> Moreover, where commodity index funds for passive investors do have swaps subject to Dodd-Frank, they will be subject to clearing and exchange-like trading.<sup>139</sup>

*5. Energy and food prices will be explained by market fundamentals rather than factors that may be attributable to excessive speculation.*

The Dodd-Frank Act *requires* the CFTC to set aggregate position limits on the amount of swaps trading that entities can conduct<sup>140</sup> with the goal of limiting excessive speculation and subsequent volatility in commodities.<sup>141</sup> Too much speculation can unmoor prices from market fundamentals such as supply and demand.<sup>142</sup> In essence, prices are usually determined by a healthy tension between commercial users, who want low prices, and producers, who want high ones. Speculators, however, are unconcerned about what a fair price for a commodity might be, but rather they want prices to move dramatically in the direction of their bets.<sup>143</sup> Since the passage of the Commodity Exchange Act in 1936, as reinforced by Dodd-Frank, position limits,

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<sup>133</sup> S. REP. NO. 111-176, at 7 (2010).

<sup>134</sup> Abigail Field, *Inside the SEC’s Legal Claim Against Goldman Sachs*, DAILY FINANCE (Apr. 16, 2010), available at <http://www.dailyfinance.com/story/investing/inside-the-secs-legal-case-against-goldman-sachs/19443106/>.

<sup>135</sup> Francesco Guerrera, *Dimon Attacks Post-Crisis Regulation*, FIN. TIMES (London), Sept. 15, 2010, at Companies – International 17.

<sup>136</sup> *Id.*

<sup>137</sup> Ke Tang & Wei Xiong, *Index Investing and the Financialization of Commodities 2* (NBER Summer Institute Workshop on Capital Markets and the Economy, Working Paper, 2009), available at <http://www.princeton.edu/~wxiong/papers/commodity.pdf>; see also AHMAD R. JALALI-NAINI, PETROLEUM STUDIES DEP’T, OPEC SECRETARIAT, *THE IMPACT OF FINANCIAL MARKETS ON THE PRICE OF OIL AND VOLATILITY: DEVELOPMENTS SINCE 2007*, 9 (2009).

<sup>138</sup> Tang & Xiong, *supra* note 137, at 6.

<sup>139</sup> *Id.*

<sup>140</sup> Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011).

<sup>141</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 737 and 763(h) (2010).

<sup>142</sup> Gerald P. O’Driscoll Jr., *The Fed Can’t Solve Our Economic Woes*, WALL ST. J., Aug. 16, 2010, at A15.

<sup>143</sup> See *Staff of Senate Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs*, EXCESSIVE SPECULATION IN THE WHEAT MARKET 152–57 (2009); *Staff of Senate Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs*, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET 29 (2007); Tang & Xiong, *supra* note 137, at 2.



when properly enforced, minimize the role of speculation by limiting both its volume and impact, allowing market fundamentals to be the primary driver of prices.<sup>144</sup>

The impact of weak position limits and excessive speculation on oil pricing was evident between 2007 and 2009, when prices rose from \$65 per barrel in June 2007, to \$145 in July 2008, to the \$30s in winter 2008-09, shifting to the \$60s and \$70s in 2009 and now back up to \$100.<sup>145</sup>

There can be little doubt that the American consumer's pocketbooks will take a serious beating because of destabilizing price spikes in traditional physical commodities, such as oil, gasoline, heating oil and basic food staples.<sup>146</sup> As one prime example, we have seen a spike in crude oil prices during the last six months: with no underlying change in supply and demand, the price of crude oscillated from \$73 per barrel in September 2010 to \$99 in February 2011, an increase of over 35 percent.<sup>147</sup> According to International Energy Agency's Oil Market Report, during the third and fourth quarters of 2011, the world oil demand increased by 0.2 mb/d.<sup>148</sup> Notably, the world oil supply increased by 0.7 mb/d.<sup>149</sup>

Furthermore, while it is true much has been said about political destabilization within oil producing countries having caused market "fears" of oil shortages, the recent surge in the oil price still seems to defy market fundamentals because Saudi Arabia, the largest world oil supplier, has offered to "make up for supplies lost because of unrest in Lybia."<sup>150</sup> The International Energy Agency said "it will release emergency stockpiles, if needed."<sup>151</sup> Most economists and market watchers acknowledge that there is not now a supply/demand problem, and that the present oil price volatility caused by "adverse" expectations should be short term as supply stability becomes clear. However, they acknowledge that permanent crude oil price spikes cannot be fully explained by either market realities or fears, but by excessive speculation. The

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<sup>144</sup> Greenberger, *supra* note 30, at 41.

<sup>145</sup> Ianthe Jeanne Dugan & Alistair MacDonald, *Traders Blamed for Oil Spike — CFTC Will Pin '08 Price Surge on Speculators, in a Reversal From Bush Findings*, WALL ST. J., July 28, 2009, at A1.

<sup>146</sup> See Sylvia Pfeifer, *Oil Price 'Threat to Recovery'*, FIN. TIMES, Jan. 4, 2011 (quoting Fatih Birol, Chief Economist, International Energy Agency, "Oil prices are entering a dangerous zone for the global economy. . . . The oil import bills are becoming a threat to the economic recovery. This is a wake-up call to the oil consuming countries and to the oil producers."), available at <http://www.ft.com/cms/s/0/056db69c-1836-11e0-88c9-00144feab49a.html#axzz1AjjrGQio>; see also Alejandro Barbajosa, *Oil Price Volatility to Increase in 2011 - HSH Nordbank*, REUTERS, Jan. 6, 2011 (quoting Sintje Diek, Oil Analyst, German Bank, "The economic development is not so bad this time and the recovery will continue, but it will not be so dynamic. At the moment, oil prices are too high for this kind of economic environment."), available at <http://uk.reuters.com/article/idUKTRE70521U20110106>; See also U.S. ENERGY INFORMATION ADMINISTRATION, CUSHING, OK WTI SPOT PRICE FOB (DOLLARS PER BARREL), available at <http://www.eia.doe.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=D>.

<sup>147</sup> See U.S. ENERGY INFORMATION ADMINISTRATION, INDEPENDENT STATISTICS & ANALYSIS ON PETROLEUM & OTHER LIQUIDS (Feb. 24, 2011), available at <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=WTOTWORLD&f=W>.

<sup>148</sup> See International Energy Agency, *Oil Market Report* (Feb. 10, 2011), available at [http://omrpublic.iea.org/World/Wb\\_all.pdf](http://omrpublic.iea.org/World/Wb_all.pdf).

<sup>149</sup> *Id.*

<sup>150</sup> Ben Sharples, *Oil Trades Near One-Week Low After Saudi Arabia Offers to Cover Supplies*, BLOOMBERG (Feb. 28, 2011), available at <http://www.bloomberg.com/news/2011-02-28/oil-trades-near-one-week-low-after-saudi-arabia-offers-to-make-up-supplies.html>.

<sup>151</sup> *Id.*

Dodd-Frank position limit mandate is designed to combat the adverse impact of too much or “excessive” speculation.

In addition to the recent oil price spike, the 2007-2008 worldwide food crisis is resurgent. Recently, the United Nation’s Food and Agriculture Organization’s economist Abdolreza Abbassian has stated: “In terms of price levels internationally I think the situation is certainly getting closer to the levels that we had seen [in 2007-2008].”<sup>152</sup> He further added that increasing food price volatility was, as a general matter, *alarming* and could *threaten future food security*.<sup>153</sup> Furthermore, the U.S. food staples prices are rising faster than overall inflation. According to the U.S. Bureau of Labor Statistics, “the consumer price index for all items minus food and energy rose 0.8% over the year to September [2010], the lowest 12-month increase since March 1961. [...] The food index rose 1.4%, however.”<sup>154</sup> Spikes in food prices have dramatically increased since September. The rise in commodity prices almost certainly cannot be *entirely* explained by supply and demand. In fact, one market participant recently stated: “We are on the verge of another commodity bull run [...] Wealthy clients are looking to buy commodity futures, physical commodities, exchange-traded funds and equities with commodity exposure.”<sup>155</sup> Notably, he also stated: “Some investors, however, are troubled about the prospect of contributing to another food price spike as seen in 2007/08 or about the sustainability of using food stocks as biofuels, raising questions about the ethics of agriculture investing.”<sup>156</sup>

As noted in footnote 11 above, the Commodity Markets Oversight Coalition has just released a listing of dozens of analyses demonstrating that excessive speculation by passive investors betting on price direction in commodity staples through derivatives causes unnecessary volatility in commodity prices. On July 24, 2009, the Senate Permanent Subcommittee on Investigations released a bipartisan 247-page staff report demonstrating conclusively that the commodity bubble in red wheat from 2004 to 2008 can be attributed to excessive derivatives speculation, as is true of the entire commodity bubble experienced during that period.<sup>157</sup> On January 13, 2011, the CFTC released by a 4-1 vote a proposed position limits rule that many consumer advocates will likely find to be a far too weak implementation of the position limit requirements of section 737 of the Dodd-Frank Act. Two of the four Commissioners voting for the proposed rule indicated that they would likely oppose that rule if it is returned in similar form as a final rule by the CFTC staff. Comments are due on that proposed rule by March 28, 2011. Hopefully, the CFTC will be persuaded by those commenters calling for greater controls of passive speculators. However, many now fear that even a weak rule implementing Dodd-Frank

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<sup>152</sup> Svetlana Kovalyova, *Food prices near '08 levels, supply stronger*, REUTERS NEWS (Nov. 2, 2010), available at <http://www.futurespros.com/news/futures-news/interview-update-1-food-prices-near-'08-levels,-supply-stronger-1000003906>.

<sup>153</sup> *Id.* (emphasis added).

<sup>154</sup> See Julie Jargon and Ilan Brat, *Food Sellers Grit Teeth, Raise Prices* *Packagers and Supermarkets Pressured to Pass Along Rising Costs, Even as Consumers Pinch Pennies*, WALL ST. J. (Nov. 4, 2010), available at <http://online.wsj.com/article/SB10001424052748704506404575592313664715360.html>.

<sup>155</sup> Laura MacInnis, *Investors primed for higher farm commodity prices*, REUTERS (Nov. 17, 2010), available at <http://www.reuters.com/article/idUSLDE6AG0U320101117>.

<sup>156</sup> *Id.*

<sup>157</sup> See PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, EXCESSIVE SPECULATION IN THE WHEAT MARKET (JUNE 24, 2009).

position limit requirements will not see the light of day, because it will not get the support of three CFTC commissioners.

If the price spike in commodity staples continues to increase, many respected economists believe it will break the back of the financial recovery and likely send the economy into a “double dip” recession. The merits of this debate cannot be resolved in this hearing, but this Committee should certainly devote substantial oversight to the causative factors of the present inflationary prices in food and energy and towards ensuring that Dodd-Frank’s position limit requirements are properly implemented at the regulatory level.

*6. Even swaps that do not clear or exchange trade will be subject to real-time reporting requirements.*

As noted above, the Dodd-Frank Act affords the CFTC and SEC the authority to require that uncleared swaps adhere to “real-time reporting.” In particular, those swaps that are not accepted for clearing must be reported to a registered swap data repository or, if no swap data repository will accept the report, to regulators in a manner that does not disclose the business transactions and market positions of any person.<sup>158</sup> The Act defines “real-time reporting” as public dissemination of data relating to a transaction, including price and volume, as soon as technologically practicable after the time at which the swap transaction has been executed.<sup>159</sup>

Also, the Act authorizes the CFTC and SEC to make swap transaction and pricing data available to the public in such forms and at such times as are deemed appropriate to enhance price discovery.<sup>160</sup> In light of this, Chairman Gensler has recently stated:

[The CFTC] anticipate[s] rules in [the data reporting] area to require swap data repositories to perform their core function of collecting and maintaining swaps data and making it directly and electronically available to regulators. . . . It will be important that swaps data be collected not only when the transaction occurs, but also for each lifecycle event and valuation over its duration.<sup>161</sup>

Under these reporting requirements, regulators will receive all relevant and necessary data in a timely manner.<sup>162</sup> As such, the reporting requirements are significant because they are one of the only ways that regulators and other observers can assess whether derivatives pose a significant risk to the market through their size or the interconnectedness of counterparties.<sup>163</sup> Indeed, the lack of reporting and transparency was a main cause of the Federal Reserve’s, the Treasury’s, and all other prudential and market regulators’ inability to anticipate the effect of undercapitalized swaps on the worldwide economy in late 2007, 2008 and early 2009.<sup>164</sup> Had the mounting synthetic CDO bets been apparent to federal regulators, they doubtless would have intervened with corrective actions much sooner.

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<sup>158</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§727, 729, 763, 764 (2010).

<sup>159</sup> *See id.* §727.

<sup>160</sup> *Id.*

<sup>161</sup> Gensler, *supra* note 32; *see also* Swap Data Repositories, 75 Fed. Reg. 80898 (proposed Dec. 23, 2010).

<sup>162</sup> Greenberger, *supra* note 30, at 42.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.*, at 14–15.

The issue of whether there will be *meaningful* “real time reporting” as Dodd-Frank contemplates or reporting of information that is too far out of date is now being hotly debated before the regulatory agencies in the proposed rulemakings. The regulatory result here bears careful watching by this Committee.