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Professor Michael Greenberger*

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

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.[1] Because tens of trillions of dollars

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1. *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, *Looters in Loafers*, N.Y. TIMES, Apr. 18, 2010, Op-Ed *available at* http://www nytimes.com/2010/04/19/opinion/19krugman html?dbk; 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/SB10001424052748704133

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 OTC derivative guarantees of the subprime housing market; and the guarantors' multi-trillion dollar interconnectedness with thousands of other OTC derivatives' counterparties within that OTC market (through interest rate, currency, foreign exchange, and energy derivatives) required taxpayers to plug the huge capital holes that cascading nonpayment would have caused, thereby leading the world's economy to crater.[2]

As it now stands, the world is still in the midst of the worst financial crisis since the Great Depression of the 1930's. This article explains the history of derivatives products, including the highly charged political events surrounding deregulation of these huge financial markets even in the face of mounting evidence of the danger that those unregulated instruments could cause the U.S. and world financial system.[3] The article then provides an overview of how recent Congressional OTC derivatives financial reform—Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")—will substantially mitigate those risks if properly implemented by federal regulators, while at the same time allowing financial markets to thrive through ensuring capital adequacy, transparency and liquidity.[4] The article ends with a vision for what the financial system would look like if Dodd-Frank is implemented as its drafters intended.[5]

THE HISTORY OF DERIVATIVES AND DERIVATIVES MARKET REGULATION

The Early Derivatives Market. Beginning in 1865, farmers and grain merchants coalesced in Chicago to hedge price risk in corn, wheat and other grains in what are thought to be the earliest sustained derivatives

80457519785229475376 6 html; Henry T. C. Hu, *"Empty Creditors" and the Crisis*, WALL ST. J., Apr. 10, 2009, at A13.

2. *See* Moshinsky *supra* note 1; Krugman *supra* note 1; Blinder *supra* note 1; Hu *supra* note 1.

3. *Infra* p. 122–23.

4. *Infra* p. 144.

5. *Infra* p. 148.

transactions in this country.[6] These kinds of derivatives have been historically referred to as futures contracts.[7]

Since their creation, derivatives markets were recognized as being subject to price distortion (*i.e.*, rather than providing hedging, they can cause payments of unnecessary and unexpected higher or lower spot prices) through excessive speculation, fraud, or manipulation.[8] As one disgruntled farmer told the House Agriculture Committee in 1892: "[T]he man who managed or sold or owned those immense wheat fields has not as much to say with the regard to the price of the wheat than some young fellow who stands howling around the Chicago wheat pit could actually sell in a day."[9]

The Origins and Purposes of the Commodity Exchange Act. Because low farm prices wreaked financial havoc on America's agriculture sector during the Depression, President Roosevelt recommended to Congress, as one of his earliest market reform proposals, legislation that became the Commodity Exchange Act of 1936.[10] When introducing this legislation in 1934, President Roosevelt said: "[I]t should be our national policy to restrict, as far as possible, the use of these [futures] exchanges for purely speculative operations."[11] Accordingly, the 1935 Report of House Agriculture Committee stated:

> *The fundamental purpose of the measure [i.e., what was to become the Commodity Exchange Act of 1936] is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves.*[12]

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6. Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States*, *1875-1905*, AMERICAN HISTORICAL REVIEW 307, 307-09 (2006) .

7. NICK BATTLEY, AN INTRODUCTION TO COMMODITY FUTURES AND OPTIONS 17-18 (2nd ed. 1995).

8. *See* Levy *supra* note 6 at 310.

9. *Id.* at 307 (quoting House Committee on Agriculture, *Fictitious Dealings in Agricultural Products: Hearing before the House Comm. on Agriculture on H.R. 392, 2699, and 3870*, 52nd Cong., 3rd sess., (1892)).

10. Public Papers and Addresses of Franklin D. Roosevelt, 3 PUB. PAPERS 81 (1938). *See also*, 7 U.S.C. §§ 6–27 (2006).

11. Roosevelt, *supra* note 10.

12. H.R. REP. NO. 421, at 1 (1935).

Thus, the Commodity Exchange Act ("CEA"), as amended, required that all futures contracts be traded on a regulated exchange providing full transparency to trading behavior and to the formation of futures prices.[13] The exchange trading requirement of the CEA was so central to that statute's policy that it is still a felony to knowingly violate it and substantial fines may be levied upon offending dealers and their employees.[14]

The Nature of Futures Contracts. The most prominent treatise on derivatives defines a "futures contract" as follows:

> *The traditional futures contact is an agreement between a seller and a buyer that the seller (called a short) will deliver to the buyer (called a long), at a price agreed to when the contract is first entered, and the buyer will accept and pay for, a specified quantity and grade of an identified commodity in the future.*[15]

While futures contracts were first developed for the agriculture sector, they expanded into metals and energy products.[16] "[T]here has been a continual [further] expansion of the futures and derivatives market [to] [f]inancial futures—on government securities, private debt issues, foreign currencies and stock indexes—an increasingly important part of the commodities world."[17]

"Standardization of terms is a key feature of publicly traded futures contracts. Under a futures contract, most customers do not expect to take delivery. . . . There is an opportunity to offset, and the customer has a right to liquidate rather than take [or make] delivery."[18] Only through the use of highly standardized products can the necessary liquidity be developed that allows traders the much needed ability to offset quickly delivery commitments in order to avoid unwanted delivery obligations.[19]

One more recent accepted method of "avoiding delivery" is to "cash settle" the futures transaction based on the market price of the futures contract, a settlement process that has been deemed by the Commodity

13. 7 U.S.C. § 6(a) (2009).

14. *Id.* § 13(b).

15. PHILLIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION, §1.02[3] at 25 (2004) (hereinafter DERIVATIVES REGULATION).

16. *Id.*

17. *Id.* § 1.02 [1] at 11.

18. *Id.* at 24–25 n. 97.

19. *Id.*

Futures Trading Commission ("CFTC") to be wholly permissible under the CEA.[20]

The Contours of the Exchange Trading Requirement. As would be expected of a market regulation bill that followed in the wake of the Securities Acts of 1933 and 1934, the contours of futures exchange regulation closely mirrored the regulation of the equities markets, *i.e.*, futures contracts were required to be traded on publicly transparent and fully regulated exchanges supported by clearing mechanisms that ensured that contractual commitments would be backed by adequate capital.[21]

Under the CEA specifically, regulated exchanges ensured that futures contracts were subject to: (1) public and transparent pricing based on market demand; (2) disclosure of the real trading parties in interest to the federal government; (3) regulation of intermediaries; *i.e.*, brokers and their employers; (4) stringent rules for customer protection; (5) self regulation by exchanges directly supervised by a federal regulator to detect unlawful trading activity; (6) prohibitions against fraud, market manipulation and excessive speculation; and (7) enforcement of all these requirements by federal regulators, private individuals and the states, the latter two through private rights of action and state *parens patriae* suits, respectively.[22]

As an integral part of this regulatory format, futures contracts also had to be cleared, *i.e.*, a well capitalized and regulated intermediary institution was required to stand between the counterparties of a futures contract to ensure that commitments undertaken pursuant to those contracts were adequately capitalized through the collection of margin.[23] Any contractual failure was guaranteed by the clearing facility, a financial commitment that served to ensure that the clearing facility had a strong incentive to enforce strictly the capital adequacy of traders, through highly disciplined assessments of the market prices of futures positions, as well as immediate collection of two types of margin: (1) initial margin upon executing a futures trade and (2) variation margin as the contract price moves against a counterparty to the trade.[24]

The Development and Characteristics of Swaps. By the 1980's, a variant of futures contracts was developed, commonly referred to as

20. *Id.* § 1.03[8] at 146–47.
21. *See id.*
22. 7 U.S.C. § 6 (2006).
23. *See id.* at § 1.18.
24. *See id.*

"swaps."[25] When first addressing swaps contracts, the CFTC defined them as "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchanges rates, or prices with payment calculated by reference to a principal base (notional amount)."[26] Similarly, the International Swaps Derivatives Association ("ISDA") defines a swap as "[a] derivative where two counterparties exchange streams of cash flows with each other.[27] These streams of cash flows are known as the 'legs' of the swap and are calculated by reference to a notional amount."[28]

A classic example of an interest rate swap transaction is where one party to the agreement exchanges a floating interest rate obligation on an existing loan for a fixed rate obligation to be paid by a swaps dealer or by another counterparty to which the swap has been assigned by the swaps dealer.[29] Usually, the person swapping the floating rate for a fixed rate is expecting (or hedging against the fact) that the fixed rate will be lower than the floating rate.[30]

In other words, the underlying loan is usually neither negotiated nor renegotiated under the swap.[31] It is an assumed amount written into the swap, most often reflecting an actual outstanding loan of one of the swaps customers from a creditor or lender upon which a floating rate is being paid to the lender.[32] The fixed interest rate payments paid by the swaps dealer to the borrower would also be specified in the transaction, as would the manner in which the floating rate would be calculated.[33] Thus, rather than buying/selling a *single* future rate or price (as would be true in a traditional futures contract), there is a "swapping" of commitments, with one party buying the fixed rate and selling the floating rate, while the other party is buying the floating rate and selling the fixed rate.[34]

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25. *See* DERIVATIVES REGULATION § 102[12A] at 29–30 (Supp. 2010).

26. Statement of Policy Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989).

27. *See* INT'L SWAP DEALERS ASS'N, INC., ISDA MASTER AGREEMENT (1992), *available at* www.isb.uzh.ch/studium/courses06/pdf/0344_1992_ISDA_MA.pdf.

28. DCG Glossary, International Swaps and Derivatives Association, Inc. website, *available at* http://www.isda.org/c_and_a/oper_commit-dcg-glossary html.

29. BATTLEY *supra* note 7 at 5–12; *see also* SATYAJIT DAS, TRADERS, GUNS AND MONEY: KNOWNS AND UNKNOWNS IN THE DAZZLING WORLD OF DERIVATIVES (rev. ed. 2010).

30. BATTLEY, *supra* note 7 at 5–12.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

Swaps and the CEA's Exchange Trading Requirement. After swaps contracts had been developed by the banks/dealers in the 1980s, with a simultaneous recognition that swaps contained all the features of a futures contract, the question arose whether swaps would be subject to the mandatory exchange trading requirement of the CEA.[35] In a 1989 Policy Statement, the CFTC set forth the criteria for the kind of swaps for "which regulation under the CEA and Commission regulations [of swaps would be] unnecessary."[36] The CFTC recognized that swaps at that time required

> *[t]ailoring . . . through private negotiations between the parties and may involve not only financial terms but issues such as representations, covenants, events of default, term to maturity and any requirement for the posting of collateral or other credit enhancement. Such tailoring and counterparty credit assessments distinguish swap transactions from exchange transactions, where the contract terms are standardized and the counterparty is unknown.*[37]

Accordingly, the CFTC exempted swaps from the CEA exchange trading requirement by stating that "swaps must be negotiated by the parties as to their material terms, based upon individualized credit determinations, and documented by the parties in an agreement or series of agreements that is not fully standardized."[38] Another condition of the exchange trading exemption is that "[t]he swap must not be marketed to the public."[39]

Because the CEA provided no explicit provision authorizing the CFTC to grant an exemption from the CEA's exchange trading requirement such as that found in the CFTC's 1989 Policy Statement, swaps dealers/banks contended that there was "uncertainty" as to the legal effect of that policy statement.[40] Thus, Congress in 1992 passed the Futures Trading Practices Act ("FTPA"), adding a new § 4(c)(5)(b) to the CEA which authorized the precise criteria for the CFTC to create exemptions from the CEA's

35. Statement of Policy Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989).

36. *Id.*

37. *Id.* (emphasis added).

38. *Id.*

39. DERIVATIVES REGULATION, *supra* note 15, at 43.

40. The *Role of Derivatives in the Financial Crisis: Hearing before the Financial Crisis Inquiry Commission*, 111th Cong. (June 30, 2010), available at http://www fcic.gov/hearings/pdfs/2010-0630-Greenberger.pdf (prepared testimony of Michael Greenberger, Law School Prof., Univ. of Md. Sch. of Law).

mandatory exchange trading requirement for, *inter alia*, "swap agreements" that "are not part of a fungible class of agreements that are standardized as to their material economic terms. . . ."[41]

The Commission later explained this statutory bar to standardization of swaps transactions as follows:

> *This condition [that swaps be individually negotiated] is designed to assure that the exemption does not encompass . . . swap agreements, the terms of which are fixed and are not subject to negotiation that functions essentially in the same manner as an exchange but for the bilateral execution of transactions.*[42]

Pursuant to the CFTC's ability to grant exceptions to the CEA's exchange trading requirement authorized by the 1992 FTPA, the CFTC by rule in 1993 provided an exception from the CEA's exchange trading requirement for those swaps that were, *inter alia*, "not part of a fungible class of agreements that are standardized as to their material economic terms[.]"[43] Moreover, exempt swaps agreements were not to be "traded on or through a multilateral transaction execution facility."[44] In laymen's terms, "a multilateral transaction execution facility" consists of one party offering electronically a swaps agreement to many different other parties, rather than merely offering agreements on a bilateral or one-on-one basis.[45]

The Standardization of Swaps through the ISDA Master Agreement. Even before the 1993 CFTC rule calling for negotiation of each of the material economic terms of swap was promulgated, the International Swaps and Derivatives Association ("ISDA" known then as the International Swaps Dealers Association) in 1992 created a standardized and copyrighted Master Agreement and related schedule to govern the execution of a swap.

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41. Futures Trading Practices Act of 1992, Pub. L. No. 102-546, § 502.

42. Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587 (Jan. 22, 1993) (emphasis added).

43. 17 C.F.R. § 35.2(b) (2009).

44. *Id.* at § 35.2(d).

45. *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, 65 Fed. Reg. 38,989, 38,989 (June 22, 2000) ("The Commission is proposing to define MTEF as 'an electronic market or similar facility through which persons, for their own accounts or for the accounts of others, enter into, agree to enter into or execute binding transactions by accepting bids or offers made by one person that are open to multiple persons conducting business through such market or similar facility.'").

ISDA "was chartered in 1985 and today has over 825 member institutions."[46]

The ISDA Master Agreement is 18 pages long with standardized, boilerplate clauses, and each page carries with it a copyright in ISDA's name.[47] It includes the fundamental provisions without which the swaps transaction could not be understood.[48] Included among the many contractual points resolved by the ISDA Master Agreement are "interpretation" principles (¶ 1); "obligations", including "liability" (¶2); "representations" (¶3); "agreements" (¶4); "events of default and termination events" (¶5); "early termination" (¶6); "transfer" (¶7); "contractual currency" (¶8); "remedies" (¶9); "expenses" (¶11); "notice" (¶12); "governing law and jurisdiction" (¶13); and forty three "definitions" governing the swaps transactions (¶14).[49]

Accompanying the ISDA Master Agreement is a "Schedule," thirteen pages long, derived directly from a standardized ISDA template for that "Schedule," which, in turn, provides a standardized menu of limited choices to further define terms of the ISDA Master Agreement.[50] The ISDA template for the Schedule is itself copyrighted on every page in ISDA's name. The ISDA standardized template for the Schedule is dependent upon, and references only, the ISDA Master Agreement.[51]

Also accompanying the ISDA Schedule is a standardized ISDA Credit Support Annex, which is sixteen pages long and also includes copyrights in ISDA's name on every page except those relating to the last of thirteen paragraphs.[52] The first twelve paragraphs within the ISDA Credit Annex are standardized boilerplate written by ISDA.[53] Every page is once again copyrighted in ISDA's name.[54] Only the last paragraph concerning "elections and variables" is not standardized.[55]

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46. News Release, Eraj Shirvani New Chairman of ISDA (April 16, 2008), *available at* http://www.isda.org/press/press041608eraj.html.

47. *See* ISDA MASTER AGREEMENT, *supra* note 27.

48. *Id.*

49. *Id.*

50. *Id.* at 19–24.

51. *Id.*

52. *See* INT'L SWAP DEALERS ASS'N, INC., CREDIT SUPPORT ANNEX TO THE SCHEDULE OF THE ISDA MASTER AGREEMENT (1995), *available at* http://kbc-pdf.kbc.be/collateral_management/Standard_csa.pdf.

53. *Id.*

54. *Id.*

55. *Id.*

The CFTC's May 1998 Concept Release. By 1998, the swaps or the "over-the-counter (OTC) derivatives" market was growing at a rapid pace.[56] As the CFTC noted:

> *Use of OTC derivatives has grown at very substantial rates over the past few years. According to the most recent market survey by [ISDA], the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-month period. The notional value of outstanding contracts in these instruments was $28.733 trillion, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994. ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of year-end 1996, up 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994. . . .*[57]

Also, these OTC derivatives were now, because of the ISDA Master Agreement, so standardized that they could be traded electronically on a multilateral basis, thereby exhibiting all of the trading characteristics of traditional exchange traded standardized futures contracts.[58] Because swaps were increasingly standardized and traded multilaterally, however, the market was not within the "safe harbors" exemption from the CEA regulatory requirements and protections of the CEA provided by the 1989 Swaps Policy Statement or the 1993 Swaps exemption.[59]

On May 7, 1998, the CFTC promulgated a concept release on OTC derivatives, finding that these standardized products were almost certainly subject to the mandatory exchange trading requirement (and therefore were trading in violation of law) and calling for public comment on the development of various alternative regulatory features that would create an § 4 (c) exemption from the CEA's mandatory exchange trading.[60]

Any new regulatory system would be applied "prospectively," with the existing market retroactively sanctioned under the CEA.[61] The public was asked to answer a series of questions pertaining to what, *if any*, of the

56. Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,115 (May 12, 1998).
57. *Id.* at 26,115.
58. *See id.* at 26,116.
59. *See id.* at 26,116–18.
60. *Id.*
61. *Id.* at 26,114.

features of a fully regulated exchange trading requirement should be applied to the swaps market, *e.g*., reporting and disclosure, capital adequacy, clearing, exchange trading, regulation of intermediaries, self regulation or application of anti-fraud and anti-manipulation principles.[62] The CFTC expressly stated that it had no preconceived notion of the answer to these questions.[63]

Pre-1998 Swaps Market Dysfunctions. The motivation for this May 1998 CFTC inquiry was the fact that unregulated swaps had caused so many financial calamities.[64] The CFTC noted:

> *A number of large, well publicized, financial losses over the last few years have focused the attention of the financial services industry, its regulators, derivatives end-users, and the general public on potential problems and abuses in the OTC derivatives market. Many of these losses have come to light since the last major regulatory actions by the CFTC involving OTC derivatives, the swaps and hybrid instruments exemptions issued in January 1993.*[65]

In footnote 6 of the concept release, the CFTC cited "Jerry A. Markham, *Commodities Regulation: Fraud, Manipulation & Other Claims,* Section 27.05 nn. 2-22.1 (1997) (listing 22 examples of significant losses in financial derivatives transactions) [and] a 1997 GAO Report 4 (stating that the GAO identified 360 substantial end-user losses)."

The most prominent scandals deriving from swaps by May 1998 included the 1994 bankruptcy of Orange County, the largest municipal default in the Nation's history.[66] Orange County was one of the country's wealthiest counties, and it's fifth most populous.[67] Having executed many poorly understood interest rate swaps, the county suddenly found itself facing massive debt as interest rates quickly rose.[68] It lost approximately $1.6 billion.[69] Merrill Lynch agreed to pay $400 million to Orange County

62. *Id.* at 26,119–27.
63. *Id.* at 26,114.
64. *Id.* at 26,115.
65. *Id*. at 26,115.
66. MARK BALDASSARE, WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 1 (1998).
67. *Id.*
68. *Id.* at 2.
69. *Id.* at 3.

to settle claims involving the derivatives that caused Orange County's bankruptcy.[70]

Also beginning in 1994, two large corporate clients of Bankers Trust, Gibson Greetings and Procter & Gamble, successfully sued that bank for defrauding them in the sale of complicated unregulated derivatives, thereby causing large customer losses.[71] Central to that litigation success were over 6,500 tape recordings of Bankers Trust employees acknowledging to each other that the bank's clients did not understand the adverse impact the derivatives transactions would have on them.[72]

The SEC and CFTC took cooperative enforcement actions against Bankers Trust for violating the antifraud provisions of the federal securities and commodities laws in connection with OTC derivatives it marketed.[73] The SEC found that Bankers Trust violated various sections of the securities laws, including making false statements or omissions in the sale of securities, supplying materially inaccurate valuations of derivatives transactions, and failing to supervise marketing personnel.[74] The CFTC asserted that Bankers Trust, by its conduct, had assumed the role of a commodity trading advisor and had violated the antifraud provisions of the CEA governing such parties' activities.[75]

Opposition to the CFTC Concept Release. The CFTC's sister agencies (the Treasury, the Federal Reserve, and the SEC) within the President's Working Group were strongly opposed to the CFTC's concept release

70. Andrew Pollack & Leslie Wayne, *Ending Suit, Merrill Lynch to Pay California County $ 400 Million*, N.Y. TIMES, Jun. 3, 1998, *available at* http://www nytimes.com/1998/06/03/business/ending-suit-merrill-lynch-to-pay-california-county-400-million html?pagewanted=all.

71. *See* Saul Hansell, *Bankers Trust Settles Suit with P.& G*, N.Y. TIMES, May 10, 1996, *available at* http://www nytimes.com/1996/05/10/business/bankers-trust-settles-suit-with-p-g html ("Paying a steep price to end a bitter battle, the Bankers Trust New York Corporation agreed yesterday to forgive most of the nearly $200 million the bank contended it was owed by Procter & Gamble over two complex transactions in 1993."); Bloomberg Business News, *Former Bankers Trust Trader Settles Charges in Derivatives Case*, N.Y. TIMES, Mar. 1, 1996, *available at* http://www nytimes.com/1996/03/01/business/former-bankers-trust-trader-settles-charges-in-derivatives-case html ("Gibson said it lost more than $6 million in derivatives trading and sued Bankers Trust. The companies settled the suit in November 1994.").

72. Kelley Holland et. al, *The Bankers Trust Tapes*, BUSINESSWEEK, Oct. 16, 1995, *available at* http://www.businessweek.com/1995/42/b34461 htm.

73. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-98-5, OTC DERIVATIVES: ADDITIONAL OVERSIGHT COULD REDUCE COSTLY SALES PRACTICES DISPUTES 8 (1997).

74. *Id.* at 44.

75. *Id.* at 46.

inquiry.[76] In response to a request from the remaining members of the President's Working Group on Financial Markets—issued on the very day the concept release was published—Congress eventually enacted a six month statutory moratorium to the CFTC concept release.[77]

The LTCM Crisis. In September 1998, Long-Term Capital Management ("LTCM"), which was up until that time the country's largest and most successful hedge fund, nearly collapsed from the loss, over a period of weeks, of $4.6 billion (or about 90% of its capital) on lost bets from, *inter alia*, OTC derivatives positions.[78] It was feared that LTCM's collapse would have created the cascading failure of many of its counterparties, which were the hedge fund's OTC derivative counterparties and creditors, including some of the world's largest financial institutions.[79] So concerned were those financial institutions about the systemic effect of LTCM's failure that, under the auspices of the New York Federal Reserve, on September 23, 1998 (with about 48 hours notice of the systemic impact of LTCM's potential collapse) fourteen of those institutions contributed a total of $3.6 billion to buy out the fund to keep it from failing.[80]

The President's Working Group's 1999 Report on LTCM. After a full day of hearings before the House Financial Services Committee on October 1, 1998 on the LTCM crisis, the President's Working Group ("PWG") was asked to prepare a report on the LTCM failure and recommend actions to prevent such a potentially systemic financial collapse in the future.[81] In April 1999, the PWG issued that report. It noted: "The near collapse of Long-Term Capital Management ("LTCM"), a private sector investment firm, highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system."[82]

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76. *Frontline: The Warning* (PBS television broadcast Oct. 20, 2009) *available at* http://www.pbs.org/wgbh/pages/frontline/warning/etc/script html.

77. *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 12–13, 15 (1999) (discussing legislation limiting the CFTC's rulemaking authority).

78. *See id.* (discussing LTCM's near collapse in September 1998 due to its inability to reduce its positions because of the large size of those positions).

79. *See id.* at 15 (describing how LTCM's counterparties' exposures were "not adequately assessed, priced, or collateralized relative to the potential price shocks the markets were facing at the end of September 1998, relative to the creditworthiness of the LTCM Fund at that time").

80. *Id.* at 14.

81. *See generally id.* at 29 (summarizing the conclusions and recommendations by the President's Working Group on Financial Markets).

82. *Id.* at viii.

One of the major recommendations of the April 1999 PWG report was that the SEC, the CFTC and the Treasury receive expanded authority to require OTC derivative counterparties to provide credit risk information, recordkeeping and reporting and data on concentrations, trading strategies and risk models, as well as providing the government the ability to inspect risk management models.[83] Fed Chairman Greenspan declined to endorse this set of recommendations, but deferred to those regulators with supervisory authority.[84]

The Counterparty Risk Management Policy Group Report on the LTCM Crisis. Shortly after the LTCM episode, twelve of the world's largest banks formed the Counterparty Risk Management Policy Group ("CRMPG") to conduct a self-study of practices that led to the LTCM crisis and to recommend self regulatory practices that would prevent such an episode from reoccurring.[85] In June 1999, CRMPG issued a detailed 57-page report, which acknowledged faulty supervision of OTC swaps' desks within their institutions and promised a broad array of management practices, including improved supervision, reporting and market practices pertaining to OTC derivatives.[86] Included within CRMPG's recommendations was a commitment to meet informally and periodically with their primary government regulator to discuss OTC market trends and conditions, including providing reports "detailing certain large exposure information on a consolidated basis group."[87]

Illustrative of a problem that would reoccur in these markets is an observation about the lack of proper documentation of OTC derivatives transactions.[88] CRMPG states:

> *The global financial markets operate through an interconnected series of contracts among market participants. . . Although written documents may not be, per se, necessary to establish a contract, they are the best evidence of the terms of a contract and the best way to ensure that parties agree on the specific terms of*

83. *Id.* at 39–40.

84. *Id.* at 40 n.23.

85. COUNTERPARTY RISK MANAGEMENT POLICY GROUP, IMPROVING COUNTERPARTY RISK MANAGEMENT PRACTICES 2 (1999).

86. *See generally id.* at 24 (discussing the improvement of risk estimation, management and reporting).

87. *Id.* at 10–11.

88. *Id.* at 37 ("Failure to document a transaction appropriately or expeditiously, therefore, creates risk.").

> *a transaction. Failure to document a transaction appropriately or expeditiously, therefore, creates risk [. . .].*[89]

The 1999 PWG Report Recommending Deregulation of Swaps. The major thrust of the CRMPG report was to oppose "new regulation . . . . It would be a mistake to attempt to codify risk management practices in that fashion."[90] Not only were no new regulations promulgated (nor were the informal meetings with regulators proposed by CRMPG ever initiated), by November 1999, the PWG (in a seeming reversal from its April 1999 Report) recommended to Congress that financial OTC derivatives totally be deregulated.[91] In a cover letter for that report, then Secretary of the Treasury Lawrence Summers explained:

> *Over-the-counter derivatives have transformed the world of finance, increasing the range of financial products available to corporations and investors and fostering more precise ways of understanding, quantifying, and managing risk. These important markets are large and growing rapidly. At the end of 1998, the estimated notional value of OTC derivative contracts was $80 trillion, according to the Bank for International Settlements. In addition, these global markets have been marked by innovation in products and trading and settlement mechanisms.*
> *A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore. . . .*[92]

The central and key recommendation within the PWG 1999 Report with respect to OTC derivatives was that Congress provide "[a]n exclusion from the CEA['s regulatory requirements] for bilateral transactions between sophisticated counterparties (other than transactions that involve non-financial commodities with finite supplies). . . ."[93]

The Commodity Futures Modernization Act of 2000's Deregulation of Swaps. Accordingly, on December 15, 2000, Congress passed and on

89. *Id.* (emphasis added).
90. Greenberger, *supra* note 40, at 9.
91. *Id.*
92. *Id.*
93. *See supra* note 78, at 2.

December 21, 2000, President Clinton signed into law the Commodity Futures Modernization Act of 2000 ("CFMA").[94] 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."[95] 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.[96]

Thus, the OTC derivatives market (at that time according to Secretary Summers amounting to $80 trillion notional value) was exempt from the CEA's capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation[97] and excessive speculation; and requirements for clearing. The SEC was similarly barred from OTC derivatives oversight except for the limited fraud jurisdiction it maintained over securities-based swaps.[98]

Recognizing that the deregulation of swaps would remove the Act's bar against excessive speculation in regulated exchange traded futures, the CFMA also expressly preempted state gaming and anti-bucket shop laws,[99] which would have barred the otherwise unregulated speculative activity authorized by the CFMA.[100]

Finally, to ensure that not even the CFMA itself could be used as a basis to challenge the legality of a swap, the Act provides that

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94. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763.

95. *See* Greenberger, *supra* note 40, at 9.

96. DERIVATIVES REGULATION, *supra* note 15, at 328–29.

97. 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 at 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 PWG that swaps concerning "finite" supplies not be removed from the exchange trading mandate of the CEA. *Id.*

98. *See* Greenberger, *supra* note 40, at 10.

99. *See* DERIVATIVES REGULATION, *supra* note 15, at 975.

100. *Id.*

> *[n]o agreement, contract, or transaction between eligible contract participants . . . shall be void, voidable, or unenforceable . . . based solely on the failure . . . to comply with the terms or conditions of an exemption or exclusion from any provision of this chapter or regulations of the Commission.*[101]

Conclusions about the Deregulatory Effect of the CFMA. In sum, what was then estimated to be the multi-trillion dollar OTC derivatives market was removed from almost all pertinent federal and state enforcement to which trading markets had been subject since the New Deal, as well as a central premise of the common law of contracts, *i.e.,* that illegal contracts are subject to a declaration of unenforceability.[102] In effect, almost no law applied to this market.[103]

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 OTC credit derivatives market as a "regulatory blackhole," based on the deregulatory provisions adopted within the CFMA.[104]

THE ECONOMIC MELTDOWN AS A FAILURE OF OTC DERIVATIVES REGULATION

Although many factors contributed to the financial meltdown of 2007 and 2008, principal among them was the collapse of the market in OTC derivatives. The OTC market in 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 financial system, were it not for a multi-trillion dollar U.S. taxpayer intervention.[105] At the time of the crisis, this market was

101. 7 U.S.C. § 25 (a)(4) (2006) (emphasis added).

102. *See* Greenberger, *supra* note 40, at 10.

103. *Id.*

104. Robert O'Harrow, Jr. and Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1(stating "'The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting in the current credit crisis,' Cox said, 'and it requires immediate legislative action.'").

105. *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; *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 (prepared testimony of Dr. Alan Greenspan).

estimated to have a notional value of $596 trillion, including approximately $58 trillion in credit default swaps ("CDSs"),[106] yet federal regulators (and most state regulators) were barred by a federal statute from ensuring stability in these transactions.[107] Before explaining below the manner in which credit default swaps (sometimes referred to as synthetic collaterized debt obligations) fomented this crisis, it is worth citing in the margin those many economists,[108] regulators,[109] market observers,[110] and financial

106. Naohiko Babo & 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.

107. 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., 2010).

108. *See* Moshinsky, *supra* note 1; Blinder, *supra* note 1; Hu, supra note 1; Krugman, 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.

109. 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"); Greenspan, *supra* note 104; Greg Robb, *Roots of Credit Crisis Laid at Fed's Door*, MARKET WATCH (Oct. 24, 2007), http://www marketwatch.com/story/roots-of-credit-crisis-found-at-the-feds-door-says-expert.

110. *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 (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), 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 Einhon] 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

columnists[111] who have described the central role unregulated CDS played in the crisis.[112]

Swaps and the Economic Meltdown. CDSs were the last step in a subprime securitization process that came to undermine the economy.[113] A counterparty investing in a CDS paid a "premium" to a counterparty for the latter to agree to "guarantee" parts of another financial instrument, a collateralized debt obligation ("CDO"), would not fail.[114] Thus, a CDS can be seen as a form of insurance on the success of specified tranches of a CDO.[115] CDOs, in turn, involved the "pulling together and dissection into 'tranches' of huge numbers of [mortgage-backed securities ("MBSs")]," based for their part on mortgage loans and, in the years before the crisis, subprime mortgages in particular.[116]

Importantly, by "reframing the form of risk (e.g., from subprime mortgages to MBSs to CDOs)," investors, providing the guarantees or insurance of the subprime market through CDSs, thought that their

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POST, March 8, 2010, *available at* 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.").

111. *See* LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (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 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.").

112. *See supra* notes 109–11.

113. 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.

114. *Id.* at 100.

115. *Id.*

116. *Id.*

investments were safe.[117] This problem was compounded by "misleadingly high evaluations" by credit rating agencies and, of course, the insurance provided by CDSs.[118] 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.[119]

Because CDSs were widely understood to be risk-free, financial institutions began writing "naked" CDSs (sometimes referred to as synthetic collateralized debt obligations) to investors who had no direct investment in CDOs or MBSs.[120] That is, investors bet with relatively small insurance-type premiums that certain handpicked mortgage-based instruments would fail, and they would receive a hefty payment if they did.[121] Estimates suggest that before the crisis, there were at least as many "naked" CDSs as those based on actual risk.[122]

All of this came to a head when housing prices began to plummet.[123] Homeowners began to default on loans, leading to the failure of CDOs and triggering obligations of CDS issuers.[124] Synthetic CDOs and naked CDSs added exponentially to the obligations owed.[125] However, because they believed that the guarantees would never be triggered, issuers had not set aside sufficient capital to pay them off and therefore could not honor their contractual commitments.[126] 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, which led to uncertainty and a tightening of credit.[127] All of this 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.[128]

The analysis surrounding this subject estimates that there may have been three to four times as many "naked" CDS instruments extant at the

117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.* at 101.
121. *Id.*
122. *Id.*
123. *Id.* at 102.
124. *Id.*
125. *Id.*
126. *Id.*
127. *Id.*
128. *Id.*

time of the meltdown than CDSs guaranteeing actual risk.[129] 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.[130] (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.)[131]

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.[132] 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.[133] An action of this sort by even a single state would have disrupted the "naked" CDS market throughout the country.[134]

Moreover, doubtless because Eric Dinallo, in his then capacity as New York Insurance Superintendent, seriously considered regulating CDS as insurance[135] and because the National Council of Insurance Legislators

129. *Id.* at 101. *See* The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm., *110th 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.

130. *See* Dinallo, *supra* note 129, at 3–4.

131. *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 (referring to rising number of Senate Democrats' opposition to cram down).

132. DERIVATIVES REGULATION, *supra* note 15, at 975 (referencing 7 U.S.C. § 16(e)(2)).

133. *See* Dinallo, *supra* note 129, at 4–5.

134. Greenberger, *supra* note 40.

135. 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.").

were working on a model code to regulate CDS as insurance,[136] 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.[137]

INTERCONNECTEDNESS: THE SYSTEMIC RISK DERIVED FROM ALL TYPES OF SWAPS

Swaps Other Than CDS Have Caused Serious Financial Dislocations. While CDSs and synthetic CDOs almost certainly lit the fuse that led to the recent explosive financial destabilization, the remainder of the OTC market has historically led to other destabilizing events in the economy. These include the recent energy and food commodity bubble,[138] the near failure of LTCM in 1998, the Bankers Trust scandal and the Orange Country bankruptcy of 1994, and now the causative factor of the European sovereign debt crisis (cross currency swaps masking the full extent of sovereign debt).[139]

Unregulated OTC Derivatives of All Kinds Cause "Too Big To Fail" Institutions. However, even if looking only at the recent financial crisis, the remainder of the unregulated OTC derivatives market was central to the crisis' causation. That is because the remainder of the OTC derivative market relates directly to the interconnectedness of swaps commitments that made large financial institutions "too big to fail." The prevention of a cascading collapse of the financial system therefore required the American taxpayer to bail out many of those huge financial entities because of their non-CDS swaps commitments.[140]

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

137. Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 722(b) (2010).

138. *See generally Hearing Before the House Energy and Commerce Subcommittee on Oversight and Investigations Regarding Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation? – Part II* (2008), *available at* http://michaelgreenberger .com/files/June_23_2008_testimony.pdf (prepared testimony of Michael Greenberger, Law School Prof., Univ. of Md. Sch. of Law); *Hearing before the Commodity Futures Trading Commission on Excessive Speculation: Position Limits and Exemptions* (2009), *available at* http://michaelgreenberger.com/files/CFTC_AFR_Sign_On_Testimony_August_3.pdf (prepared testimony of Michael Greenberger, Law School Prof., Univ. of Md. Sch. of Law).

139. Louise Story et. al, *Wall St. Helped to Mask Debts Shaking Europe*, N.Y. TIMES, Feb. 13, 2010, at A0.

140. *See* Johnson, *supra* note 111, at 117–33 ("America cannot end Too Big to Fail without derivatives reform.").

The Lehman Bankruptcy. As the Lehman bankruptcy proceedings revealed, Lehman was a counterparty or guarantor of over 930,000 OTC derivatives.[141] To the extent that these contracts did not involve CDS, they certainly involved unregulated interest rate, currency, foreign exchange, and energy swaps.[142]

The Lehman liquidators are now embarked in a huge battle with Lehman's OTC derivative counterparties, claiming that those counterparties have greatly exaggerated the value of amounts owed by Lehman pursuant to those derivatives.[143] The liquidators have filed a law suit against Nomura, which has submitted $1 billion in counterparty swaps claims to the Lehman estate. Lehman asserts that [a]bout 6,000 derivatives claims—totaling $60bn in losses—were filed against Lehman's US estate . . . , including claims from about 40 of the largest US banks."[144]

Bear Stearns Interconnectedness. As further evidence of the interconnectedness of OTC derivative counterparties, on April 3, 2008, New York Fed President Timothy Geithner explained after the Bear Stearns collapse:

> *The sudden discovery by Bear's derivative counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to replicate those positions in already very fragile markets.*[145]

141. GuyLaine Charles, *OTC Derivative Contracts in Bankruptcy: The Lehman Experience*, 13 N.Y. BUS. L. J. 14, 16 (2009).

142. *See id.;* Andrew Ackerman, *Court to Decide Fate of Lehman Contracts*, THE BOND BUYER, Dec. 15, 2008, http://www.bondbuyer.com/issues/117_238/-297451-1 html ("Though . . . [Lehman Brothers Holdings] does not provide specific numbers for each category of swap, derivatives market participants believe that roughly 20% to 30% of the contracts are municipal securities-based interest rate swaps.").

143. Megan Murphy & Anousha Sakoui, *Nomura Sued over Lehman Claims*, FINANCIAL TIMES, Apr. 24, 2010 at 9.

144. *Id.*

145. Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc., to the Shareholders of Berkshire Hathaway Inc. (Feb. 27, 2009), *available at* http://www.berkshirehathaway.com/letters/2008ltr.pdf.

Citing this quote, Warren Buffet concluded: "This is Fedspeak for [']We stepped in to avoid a financial chain reaction of unpredictable magnitude.['] In my opinion, the Fed was right to do so."[146]

AIG Interconnectedness. Of course, it was the very failure of Lehman, and the cascading adverse and substantial impacts its bankruptcy has caused, that led the Federal Reserve and the Treasury to alter course on the day after Lehman's failure, to prevent AIG's bankruptcy and then to recommend the TARP bailout.[147] Those actions revealed to the world the correlation between interconnectedness of unregulated OTC swaps transactions and the too big to fail phenomenon.[148]

Again, the great portion of the taxpayer funds that went into the front door of AIG to "save it" went out the back door as payments to its derivatives counterparties.[149] As the recent report of the Congressional Oversight Panel ("COP") on the AIG bailout makes clear, billions of the taxpayer bailout went 100 cents on the dollar to AIG's derivatives counterparties.[150] In this regard, COP observed as to AIG's derivatives book:

> *In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors . . . . But rather than sharing the pain among AIG's creditors[,] . . . the government instead shifted those costs in full onto taxpayers . . . . The result was that the government backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings*

146. *Id.*

147. CONGRESSIONAL OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY, 53 (June 10, 2010), *available at* http://cop.senate.gov/documents/cop-061010-report.pdf (last visited on June 27, 2010).

148. *See* Jill E. Sommers, Remarks Before the Capital Markets Consortium: Clearinghouse as Mitigators of Systematic Risk (Sept. 30, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/CommissionerJillESommers/opasommers-10 html ("One of the lessons that emerged from the recent financial crisis was that institutions were not just "too big to fail," but also too interconnected through non-transparent swaps that the institutions did not effectively manage.").

149. *See* Alexander Sellinger, *Backdoor Bailout Disclosure: Must the Federal Reserve Disclose the Identities of its Borrowers Under the Freedom of Information Act?*, 15 FORDHAM J. CORP. & FIN. L. 259, 260–261 (2009) (explaining the view that the billions used to bail out AIG was really a back door bailout to other counterparties who continued to gamble with the funds); Gretchen Morgenson, *At A.I.G., Good Luck Following the Money*, N.Y. TIMES, March 15, 2009, at BU2 (revealing the counterparties that taxpayers bailed out with the funds allocated to A.I.G. "include Goldman Sachs, Merrill Lynch and two French banks, Calyon and Societe Generale.").

150. CONGRESSIONAL OVERSIGHT PANEL, *supra* note *147,* at 286.

> *deposits and checking accounts. [E]very counterparty received exactly the same deal: a complete rescue at taxpayer expense.*[151]

All Swaps Are Masked By Opaque Accounting Principles. A final reason that all derivatives — not just credit derivatives —played a role in the onset of the crisis is that they were never properly accounted for on balance sheets.[152] Because of a major lobbying effort by ISDA, for example,

> *[b]anks and corporations that trade swaps do not play by the same rules as other individuals and businesses. Banks are permitted to exclude their full exposure to swaps from their financial statements, and instead report only the 'fair value' changes in those swaps over time. Such reporting is like an individual reporting only the change in their debt balances, instead of the reporting the debts themselves.*[153]

Thus, prior to the meltdown, swaps of all kinds were masked by a double barrier of opacity*, i.e.,* not only were they private and bilateral, but they were even hidden on the balance sheets of those institutions most likely to suffer from their adverse impact.[154] This kind of balance sheet opacity blinded regulators and market observers from the explosive and toxic nature of the contractual obligations embedded in swaps.[155] And, when the crisis became full blown in September 2008, this opacity led both the extenders of credit and policy makers to fear the worst.[156] As a result bank lending froze up, causing the credit crisis.[157]

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151. *Id.* at 9.

152. Frank Partnoy & Lynn E. Turner, *Bring Transparency to Off-Balance Sheet Accounting*, *in* ROOSEVELT INSTITUTE: MAKE MARKETS BE MARKETS 85, 88 (2010), *available at* http://makemarketsbemarkets.org/report/MakeMarketsBeMarkets.pdf.

153. *Id.*

154. *See id.* at 86–88 (explaining how off-sheet balances of swaps were created by banks and private businesses and were hidden from investors).

155. *Id.* at 87.

156. *See, e.g.,* Ben White & Vikas Bajaj, *Mounting Woes at Citigroup Began with Bank's Failed Bid for Wachovia*, N.Y. TIMES, Nov. 22, 2008, at B0 (explaining how the financial collapse of Citigroup and defaults on major commercial loans "renewed fears that a vast wave of damaged commercial loans would course through banks . . . already hit by a tsunami of toxic mortgage products.").

157. *See* Partnoy & Turner, *supra* note 152,at 87.

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.[158] The Dodd-Frank Act transforms the regulation of OTC derivatives by generally requiring that swaps be subject to clearing and exchange-like trading, including capital and margin requirements.[159]

The Act first requires that all "swap dealers" and "major swap participants" register with the appropriate banking regulators, the CFTC, and/or the SEC.[160] 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.[161] 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.[162]

Registered swap dealers and major swap participants must disclose any material risks of swaps and any material incentives or conflicts of interests.[163] 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).[164] They must also conform to position limits on their trading volume in commodity

158. Brady Dennis, *Obama Ushers in New Financial Era; Landmark Law is Signed President Says Work Still Lies Ahead for Regulators*, WASH. POST, July 22, 2010, at A13.

159. BAIRD WEBEL ET AL., CONG. RESEARCH SERV., R40975, FINANCIAL REGULATORY REFORM AND THE 111TH CONGRESS, 12 (2010) *available at* http://assets.opencrs.com/rpts/R40975_20100601.pdf ("H.R. 4173 . . . mandate 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.").

160. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731(a) (2010).

161. *Id.* § 721(a).

162. *Id.*

163. *Id.* §§ 731(h)(3)(B), 764(g)(3)(B)(i) –(ii).

164. *Id.* §§ 731(e), 764(e)–(h).

swaps, which are to be set by standards established by the regulators.[165] The Dodd-Frank Act also requires that swaps transactions be reported.[166]

The Dodd-Frank Act imposes the clearing and exchange-like trading requirements on standardized swap transactions.[167] Both types of regulation are central features of the CEA's regulation of futures.[168] 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.[169] 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.[170] 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.[171] DCOs must allow "non-discriminatory" access to clearing.[172] Swaps that are required to be cleared must also be traded on a designated contract market, securities exchange or swap execution facility ("SEF").[173] Swaps do not have to be cleared or exchange traded if no existing entity lists a particular swap product.[174]

The Dodd-Frank Act contains a narrow "end-user" exception designed to ease the burden on businesses using swaps to mitigate risk associated with their commercial activities.[175] For example, airlines buying fuel may

165. *Id.* §§ 737, 763(h).

166. *Id.* § 727(c).

167. *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. 65,882 (Oct. 26, 2010) (explaining some of the regulations the Dodd-Frank Act imposes on swap transactions).

168. Greenberger, *supra* note 133, at 99.

169. *Id.*

170. *Id.*

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

172. *Id.* § 763(a)(2)(B).

173. *Id.* §§ 723(e), 763(a)(2)(B).

174. *Id.* § 763.

175. *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, The Honorable Chairman, Financial Services Committee, & Colin Peterson, The Honorable Chairman, Committee on Agriculture, (June 30, 2010), *available at* http://www.wilmerhale.com/files/upload/June%2030%202010%20Dodd_Lincoln_Letter.pdf (explaining the end-user exception is "for those entities that are using the swaps market to hedge or mitigate commercial risk.").

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 how they meet financial obligations of non-cleared swaps.[176] It does not cover swaps in which both parties are major swap participants, swap dealers or other financial entities.[177]

Despite the end-user exception, the Dodd-Frank Act imposes its reporting requirements for all swaps, whether or not they are cleared.[178] 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.[179] Margin requirements technically apply to all swaps, although the Act's sponsors have stated that they are not intended to apply to end-users.[180]

One of the more controversial provisions 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.[181] Federal assistance is defined broadly to include, *inter alia*, federal deposit insurance or access to the Federal Reserve's discount window.[182] 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.[183]

Similarly, the Volcker Rule generally prohibits banks from engaging in proprietary trading (that is, trading that is on its own behalf and not a

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

177. *Id.*

178. *Id.* §§ 727, 731, 764.

179. *Id.* §§ 727, 729, 763, 764.

180. *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/Cleary%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.").

181. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716 (2010).

182. *Id.*

183. *Id.*

customer's) or acquiring or retaining an interest in a hedge fund or private equity fund.[184] While the Volcker Rule will not be implemented immediately,[185] the consequence almost certainly is that many of these activities will also move from banks to other smaller and less systemically risky entities.[186]

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.[187] 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 whether it is done by banking regulators or by a court.[188] 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. . . .*[189]

HOW WILL WE KNOW IF THE DODD-FRANK ACT IS WORKING?

Dodd-Frank has been hailed as an important and comprehensive financial reform.[190] But like many reforms before it, proof of its success lies not in

184. *Id*. § 619.

185. *Id.* 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.*

186. Greenberger, *supra* note 107, at 38.

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

188. *See* Johnson, *supra* note 111, at 123.

189. *Id*.

190. *See, e.g.*, Dennis, *supra* note 158 ("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 text of the law, but in how it is administratively implemented. In five years, for example: 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 have:

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

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.[191] As CFTC Chairman Gary Gensler has said, the "exception should be narrowly 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."[192]

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.[193] 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

191. *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.).

192. 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).

193. *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).

management of a *commercial enterprise*."[194] 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."[195] Such an approach would be sufficiently narrow to limit the ability of entities to circumvent regulation.

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.[196] 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 information on who is involved in trading and to what extent.[197] But if large numbers of trading institutions are excluded from clearing organizations or exchanges, the protections otherwise contributed by these requirements will be undermined.[198]

Already, large swap dealers and banks are working to limit access and competition from smaller entities by creating ways to exert control over DCOs, BOTs, and SEFs.[199] According to the Office of the Comptroller of the Currency, just five U.S. banks represent 98% of the total amount

194. *See id.,* at n.49 (citing 17 CFR 1.3(z)(1)).

195. *See* Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144, 4159 (Jan. 26 2010).

196. *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/dfsubmission/dfsubmission9_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].

197. 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.").

198. Greenberger, *supra* note 107, at 39.

199. *Id*.

invested by banks in swaps.[200] In many cases, clearinghouses and exchanges are owned by banks, including those that are the five dominant swaps investors.[201] In an apparent attempt to discourage competition, the 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.[202]

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.[203] 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.[204] Although the Lynch amendment was stripped 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 debt or material equity investment."[205] In carrying out the duties

200. 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).

201. *E.g.*, CFTC/SEC Roundtable, *supra* note 196, at 112 (statement of Michael Greenberger) (stating that one exchange's ownership structure includes nine banks taking 50% of profits).

202. *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).

203. 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.

204. *See* H.R. REP. NO. 111-370, pt. 5, at 188 (2009).

205. 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).

expressly delegated by the Act, the CFTC and SEC have complete and unfettered discretion to create restrictions on ownership—including numerical caps.[206] 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 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.[207] 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.[208] 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.[209] In order to mitigate the potential conflicts of

206. 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 196, 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).

207. *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).

208. INTERCONTINENTALEXCHANGE, ANNUAL REPORT 2 (2009), *available at* http ://materials.proxyvote.com/Approved/45865V/20100323/AR_56919/images/IntercontinentalExch ange-AR2009.pdf.

209. *ICE Trust to Begin Processing and Clearing Credit Default Swaps March 9*, The Clearing Corp., Mar. 6, 2009, *available at* http://www.clearingcorp.com/press/pressreleases/20090306-ice-process-cds html.

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 DCO, DCM and SEF.[210] However, when confronting the kind of massive concentration of 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.[211] 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").[212] These entities should be encompassed by the definitions adopted by the CFTC.

To achieve this number, 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."[213] 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

210. Rachelle Younglai & Roberta Rampton, *FACTBOX-Differences in SEC, CFTC Clearinghouse Proposals*, REUTERS, Oct. 13, 2010, *available at* http://www reuters.com/article/ idUSN1318594320101013.

211. Greenberger, *supra* note 107, *at* 40.

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

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

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.[214] 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.[215]

Because trading revenue from swaps activities is currently unavailable to the public or regulators,[216] in order to allow regulators to assess this percentage, the regulators should require 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.[217]

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 can paint a picture of

214. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721(a)(21) (2010).

215. Greenberger, *supra* note 107, at 40.

216. *Id*.

217. *Id.*

how concentrated risk is, and regulators can use it 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.[218] 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.[219] 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.[220]

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 "Volker 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*, commodity swaps dealings and unregulated CDSs in order to benefit from federal assistance.[221] Although both

218. *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.

219. *See* OCC Report, supra note 200, at 4 ("Net current credit exposure is the primary metric used by the OCC to evaluate credit risk in bank derivatives activities.").

220. *See generally* DEP'T OF TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009).

221. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 619 and 716 (2010).

provisions have long lead times before implementation, they are already having their intended effects.[222]

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.[223] 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.[224] At Goldman Sachs, proprietary traders are reportedly leaving to join new or existing hedge funds.[225] JP Morgan recently announced it will shut down its proprietary trading in commodities as a first step in closing down all proprietary trading.[226] All of these firms, and traders within them, have stated that they are taking action for to resolve regulatory uncertainty, so that they are not ". . .worrying about what they're going to be doing a couple of years from now. . . ."[227]

This movement is healthy—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, for example, hedge funds. As the Senate Committee on Banking suggested, the Volcker Rule ". . .will reduce the scale, complexity, and interconnectedness of 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."[228] In addition, investment banks will not be able to create risky financial

222. 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.

223. Martin Arnold & Francesco Guerrera, *Buy-out Spin-off Move by B of A*, FIN. TIMES (London), Aug. 4, 2010, at Companies – International 19.

224. *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.

225. 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.

226. Kopecki & Chanjaroen, *supra* note 224.

227. Harper & Kishan, *supra* note 225.

228. S. REP. NO. 111-176, at 7 (2010).

products and sell them to investors, while holding on to the other side of the bets to make profits at customers' expense.[229]

The Lincoln or Push-Out Rule is also already driving risky trades into more diverse structures.[230] JP Morgan, for example, is spinning off its high-risk commodity derivatives into a unit that will be separate from its other investments.[231] 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.[232] 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.[233] Moreover, where commodity index funds do have swaps subject to Dodd-Frank, they will be regulated.[234]

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 position limits on the amount of swaps trading that entities can conduct, with the goal of limiting speculation and subsequent volatility in commodities.[235] Speculation can unmoor prices from market fundamentals such as supply and demand.[236] In essence, prices are usually determined by a healthy tension between

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

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

231. *Id.*

232. 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).

233. Tang & Xiong, supra note 232, at 6.

234. *Id.*

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

236. Gerald P. O'Driscoll Jr., *The Fed Can't Solve Our Economic Woes*, WALL ST. J., Aug. 16, 2010, at A15.

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.[237] Position limits will minimize the role of speculation by limiting both its volume and impact, allowing market fundamentals to be the primary driver of prices.[238]

The impact of 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.[239] More recently, oil has been threatening to back to record high levels reached in mid-2008.[240]

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 at a derivatives clearing organization 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

237. *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 232, at 2.

238. Greenberger, *supra* note 107, at 41.

239. 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.

240. *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), http://www.eia.doe.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=D.

positions of any person.[241] 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.[242]

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.[243] In light of this, Chairman Gensler has recently stated that

> *[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.*[244]

Under these reporting requirements, regulators will receive all relevant and necessary data in a timely manner.[245] As such, the reporting requirements are significant because they are one of the only ways that regulators and other observers can assess whether derivatives are significant enough to pose risk to the market through their size or the interconnectedness of counterparties.[246] Indeed, the lack of reporting and transparency was a main cause of regulators' inability to anticipate the effect of undercapitalized swaps on the financial markets in 2007 and 2008.[247]

CONCLUSION

Untouched by the traditional norms of market regulation, the unsupervised multi-trillion dollar swaps market helped create a highly speculative derivative bubble that was opaque to federal regulators and market observers alike.[248] Thus, the swaps market permitted trillions of dollars of

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

242. *See id.* §727.

243. *Id.*

244. Gensler, *supra* note 109.

245. Greenberger, *supra* note 107, at 42.

246. *Id*.

247. Greenberger, *supra* note 40, at 14–15.

248. *Id*. at 21.

financial commitments to be made with no assurance that those commitments could be fulfilled—beyond the false comfort of the highly illusory and wholly inappropriate AAA-ratings of the counterparties in question and/or the instruments to be insured.[249]

In contrast, had the norms of market regulation been applicable to OTC derivatives, swaps transactions would have been adequately capitalized by traditional clearing practices, and the dangers building up in swaps markets would otherwise have been observable by regulators, investors, academics and market observers thanks to the transparency and price discipline that accompanies exchange trading.[250] These protections would have been applicable not only to the CDS market, but to other derivatives transactions that contributed to the crisis, including interest rate, currency, foreign-exchange and energy swaps.[251]

Dodd-Frank's mandate for capital adequacy and transparency in derivatives markets is Congress' answer to the financial crisis, and the contours of the Act hold great promise for helping to avoid a similar crisis in the future. The true test of the Dodd-Frank Act, however, is simple but profound: Has it made the economy any safer from the threat of another economic meltdown? The Act has the potential to effectively regulate the derivatives markets, if regulators make the most of the tools made available to them by Dodd-Frank.[252]

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249. *Id*.
250. *Id.*
251. *Id.*
252. Greenberger, *supra* note 107, at 42.