Out of the Black Hole
Regulatory Reform of The Over-the-Counter Derivatives Market

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A litany of factors, including lending and financial abuses, led to the subprime meltdown and resulting deep recession. But chief among them was the opaque and unregulated over-the-counter ("OTC") derivatives (often referred to as "swaps") market, which was estimated to have a notional value of $596 trillion at the time of the crisis.[1]

The Exchange Trading and Clearing Requirements for All Derivatives Prior to Passage in 2000 of the Highly Deregulatory Commodity Futures Modernization Act

Prior to December 20, 2000, the OTC derivatives market was generally understood to be subject to regulation under the Commodity Exchange Act ("CEA"), because OTC products were a form of futures contracts. Under the CEA, all futures contracts were required to be traded on publicly transparent and fully regulated exchanges. Trading on such exchanges meant that futures contracts were regulated to insure: (1) public and transparent pricing; (2) disclosure of the real trading parties in interest to the federal government; (3) regulation of intermediaries, i.e., brokers and their employers, including stringent rules as to capital adequacy and customer protection; (4) self regulation by exchanges directly supervised by the Commodity Futures Trading Commission ("CFTC") to detect unlawful trading activity; (5) prohibitions against fraud, market manipulation and excessive speculation; and (6) enforcement of all these requirements by the CFTC and by private individuals and the states through private rights of action and state parens patriae suits.

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. Any contractual failure was guaranteed by the clearing facility, a financial commitment that served to insure that the clearing facility had a great incentive to strictly enforce the capital adequacy of traders.

The Commodity Futures Modernization Act of 2000 Ends Regulatory Oversight of OTC Derivatives

On December 20, 2000, the Commodity Futures Modernization Act ("CFMA") was passed. That legislation was rushed through Congress and enacted by both Houses of Congress on the last day of a lame duck session as a rider to an 11,000 page omnibus appropriation bill.[2] The 262 page bill was presented to the Senate for the first time on the day that it passed. The CFMA removed OTC derivative transactions, including energy futures transactions, from all requirements of exchange trading and clearing under the CEA. Thus, in one fell swoop, the OTC market was exempt from capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation and excessive speculation; and requirements for clearing. Thus, a market that now has a notional value of many times the world's GDP is a completely private bi-lateral financial market wholly opaque to the world's market regulators, including the U.S. financial safety and soundness overseers.

Credit Default Swaps and the Economic Meltdown in the Fall of 2008

In September 2008, the unregulated OTC market included what was estimated to be $35-65 trillion in credit default swaps ("CDSs").[3] It is now conventional wisdom that the unregulated multi-trillion dollar OTC CDS market fomented a mortgage crisis, then a credit crisis, and finally a "once-in-a-century" systemic financial crisis that, but for trillion dollar U.S. taxpayer interventions, would have in the fall of 2008 completely destroyed the worldwide financial system.[4]

In warning Congress about badly-needed financial regulatory reform efforts when it considered the TARP legislation in Senate hearings before the Senate Banking Committee in September, 2008, then-SEC Chairman Christopher Cox called the CDS market a "regulatory blackhole" in need of "immediate legislative action."[5] Former SEC Chairman Arthur Levitt and even former Fed Chair Alan Greenspan – both of whom supported the CFMA in 2000 – have acknowledged that the deregulation of the CDS market contributed greatly to the fall 2008 economic downfall.[6]

To understand the central role played by CDSs in the recent meltdown, we must comprehend the subprime securitization process. In brief, the securitization of subprime mortgage loans evolved to include mortgage backed securities ("MBS") within highly complex collateralized debt obligations ("CDOs"). These securitizations were the pulling together and dissection into "tranches" of huge numbers of MBS, theoretically designed to diversify and offer gradations of risk to those who wished to invest in subprime mortgages.

However, investors became unmoored from the essential risk underlying loans to non-credit worthy individuals by the continuous reframing of the form of risk (e.g., from subprime mortgages to MBS to CDOs); the false assurances given by credit rating agencies that were misleadingly high evaluations of the CDOs; and, most importantly, the "insurance" offered on CDOs in the form of CDSs.

The CDS "swap" was the exchange by one counter party of a "premium" for the other counterparty's "guarantee" of the financial viability of a CDO. While CDSs have all the hallmarks of insurance, issuers of CDSs in the insurance industry were urged by swaps dealers not to refer to it as "insurance" out of a fear that CDSs would be subject to insurance regulation by state insurance commissioners, which would have included, inter alia, strict capital adequacy requirements.[7] By using the term "swaps," CDSs fell into the regulatory "blackhole" afforded by the CFMA's "swaps" exemption (Section 2 (g)) because no federal agency had direct supervision over, or even knowledge of, the private, bilateral world of "swaps."

Because a CDS was deemed neither insurance nor an instrument otherwise regulated by the federal government, issuers were not required to set aside adequate capital reserves to stand behind the guarantee of CDOs. The issuers of CDSs were beguiled by the utopian view (supported by ill considered mathematical algorithms) that housing prices would always go up. They believed that even a borrower who could not afford a mortgage at initial closing would soon be able to extract that appreciating value in the residence to refinance and pay mortgage obligations. Under this utopian view, the writing of a CDS was deemed to be "risk free" with a goal of writing as many CDSs as possible to develop what was considered to be the huge cash flow from the CDS "premiums."

To make matters worse, CDSs were deemed to be so risk-free (and so much in demand) that financial institutions began to write "naked" CDSs, i.e., offering the guarantee to investors who had no risk in any underlying mortgage backed instruments or CDOs. (Under state insurance law, this would be considered insuring someone else's risk, which is flatly banned.) Naked CDSs provided a method to "short" the mortgage lending market. In other words, it allowed speculators to place the perfectly logical bet for little consideration (i.e., the relatively small premium) that those who could not afford mortgages would not pay them off.

The literature surrounding this subject estimates that three times as many "naked" CDS instruments were extant than CDSs guaranteeing actual risk.[8] 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 a financial institution or hedge fund's naked CDS bet that mortgages would not be paid. (Of course, holders of those bets formed a strong political constituency against the "rescue" of subprime borrowers through the adjustment of mortgages to keep homeowners from defaulting. If the homeowner stays in the house, the bet is lost!)

Finally, the problem was further aggravated by the development of "synthetic" CDOs. Again, these synthetics were mirror images of "real" CDOs, thereby allowing an investor to play "fantasy" securitization. That is, the purchaser of a synthetic CDO did not "own" any of the underlying mortgage or securitized instruments, but was simply placing a "bet" on the financial value of the CDO that is being mimicked. Synthetic CDOs are also OTC derivatives and therefore not subject to federal regulation. Synthetic CDOs were also "insured" through CDSs.

Because both "naked" CDS and "synthetic" CDOs were nothing more than "bets" on the viability of the subprime market, it was important for this financial market to rely upon the fact that the CFMA expressly preempted state gaming and anti-bucket shop laws.[9]

It is now common knowledge that:

1. Issuers of CDSs did not (and many will not) have adequate capital to pay off guarantees as housing prices plummet, thereby defying the supposed "risk free" nature of issuing huge guarantees for the relatively small premiums that were paid.
2. Because CDSs are private bilateral arrangements for which there is no meaningful "reporting" to federal regulators, the triggering of the obligations there under often came as a "surprise" to both the financial community and government regulators.
3. As the housing market worsened, new CDS obligations were unexpectedly triggered, creating heightened uncertainty about the viability of financial institutions who had, or may have, issued these instruments, thereby leading to the tightening of credit.
4. The issuance of "naked" CDS increases exponentially the obligations of the CDS underwriters in that every time a subprime mortgage defaults there is both the real financial loss and the additional losses derived from failed bets.
5. The securitization structure (i.e., asset backed securities, CDOs and CDSs) is present not only in the subprime mortgage market, but in the prime mortgage market, as well as in commercial real estate, credit card debt, and auto and student loans. As of this writing, the financial media is filled with concerns that forfeitures in the commercial real estate market will worsen substantially, thereby triggering CDSs and naked CDSs for which there will almost certainly be insufficient capital to pay the guarantees. This restarts the downward cycle that drove the country into recession to begin with.[10]

The Potential for Systemic Risk Derives from All Types of Swaps

Moreover, while CDSs and synthetic CDOs 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 (energy and agriculture swaps), the failure of Long Term Capital Management in 1998 (currency and equity swaps), the Bankers Trust scandal and the Orange Country bankruptcy of 1994 (interest rate swaps); and now the sovereign debt crisis in Southern Europe (currency, interest rate and credit default swaps).

Prior Unsuccessful Regulatory Attempts To Oversee the OTC Swaps Market

Because "swaps" are risk shifting instruments or, in their most useful sense, hedges against financial risk, they were almost certainly subject to the Commodity Exchange Act prior to the passage of the CFMA in 2000. The CFTC in 1993 exempted swaps from the CEA's exchange trading requirement if none of their material economic terms were standardized and if they were not traded on a computerized exchange.[11] This exemption was justified under the regulatory theory that highly customized swaps could not evolve into the kind of "cookie cutter" transactions that cause systemic risk. However, the 1993 exemption did not satisfy the financial services sector, which wanted to sell almost exclusively standardized swaps that did not require the time-intensive effort that negotiating customized swaps requires. By 1998, the market grew to over $28 trillion in notional value, with swaps dealers choosing to disregard completely the exchange trading and clearing requirements within the CEA. The overwhelming majority of these instruments derive from a boilerplate, standardized and copyrighted template (the "Master Agreement") prepared by the International Swaps Derivatives Association ("ISDA"), which represents over 800 financial institutions worldwide.

As a result, in May 1998, the CFTC, under the leadership of then Chairperson Brooksley Born, issued a "concept release" inviting public comment on how that multi-trillion dollar OTC industry might most effectively be regulated pursuant to the CEA on a "prospective" basis.[12] The concept release was premised on 22 economically destabilizing events that had been caused by unregulated OTC instruments up to that time.[13] The 1998 CFTC concept release spelled out a menu of regulatory tools for the OTC market that have historically been applied to financial markets since the passage of the Securities Act of 1933 and 1934 and the Commodity Exchange Act of 1936 in the early New Deal. These include equities, options and traditional futures contracts, which, if unregulated, would have the financial force to destabilize the economy systemically upon forfeiture of commitments.

The CFTC effort was first blocked by Congress on the recommendation of the remaining members of the President's Working Group (i.e., the then Secretary of the Treasury, the Chairman of the Federal Reserve and the Chairman of the SEC). Despite the intervening collapse due to OTC trading and rescue of the world's largest hedge fund at the time (Long Term Capital Management), Congress in 2000 passed the CFMA. This act affirmatively removed OTC derivatives from virtually all federal regulation and oversight.

New Deal Norms for Regulating Systemically Risky Financial Markets

As a result of the response to the failure of financial markets in the 1920s, the Roosevelt Administration actively sought and aggressively supervised the passage of the Securities Acts of 1933 and 1934 and the Commodity Exchange Act of 1936. Prior to the 2000 passage of the CFMA, these reforms established the following classic regulatory norms governing the equities and futures markets:

1. *Transparency*. By almost always requiring that systemically risky financial instruments be exchange traded, the public has access to the regular mark to market pricing of these instruments. Moreover, in the case of regulated futures contracts, the CFTC has access to commitment of traders' reports and large trader reporting so it can determine the real parties in interest involved in large trades. Transparency should also require that all transactions and holdings be clearly accounted for on audited financial statements. The recent meltdown has been characterized by the use of off balance sheet investment vehicles, e.g., structured investment vehicles ("SIVs"), to house and

mask those instruments with potential systemic risk hidden from public view.

2. *Record Keeping*. Traders and intermediaries on regulated markets are required to keep and maintain records of transactions. Not only is there no record keeping requirements in the OTC market, but there is a serious problem of record "creation." Since August 2005, the New York Fed has complained that financial instruments pertaining to credit derivatives have been poorly documented with back offices being very far behind the execution of credit derivatives by sales personnel.[14]
3. *Capital Adequacy*. Intermediaries conducting trades and the traders themselves in regulated markets have capital adequacy requirements to ensure fulfillment of financial commitments.
4. *Disclosure*. Intermediaries and the marketers of financial instruments are traditionally required to provide full and meaningful disclosure about the risks of entering into a regulated transaction.
5. *Anti-fraud and anti-manipulation authority*. The regulated financial markets are governed by statutes that bar fraud and manipulation. The CFMA, however, provides only limited fraud protection for counterparties engaged in securities-based or energy-based OTC derivatives – but affords no such protection for interest rate or currency OTC swaps. The inadequacy of even the security-based protection is evidenced by both former SEC Chairmen Cox and Levitt calling regulation of these markets a "regulatory blackhole."[15] Fraud protection without transparency of transactions to the federal regulator is meaningless.
6. *Regulation of Intermediaries*. "Brokers" of equity and regulated futures transactions are subject to registration, competency examinations and adherence to prudential conduct. Not only is there no such protection within the swaps market, but pursuant to the ISDA Master Agreement, which governs most swaps transactions, the non-bank counterparty undertakes that it is not relying on representations of the marketer of swaps and otherwise must certify that the transaction is in accordance with U.S. law and the law of all of the states. This amounts to caveat emptor on steroids.
7. *Private Enforcement*. As is true in securities laws and laws applying to the regulated futures, private parties in the swaps markets should have access to courts to enforce anti-fraud and anti-manipulation requirements and to challenge all other unlawful activities, thereby not leaving enforcement entirely in the hands of overworked (and sometimes unsympathetic) federal enforcement agencies. Similarly, under the CEA, appropriate state officials may bring such actions on behalf of citizens of the state adversely affected by illegal futures transactions, i.e., parens patriae actions. Because the OTC derivatives market operates outside of almost all regulatory obligations, private rights of action and parens patriae actions are essentially undercut because there are no "rights" to enforce.
8. *Mandatory Self Regulation*. As is true of the securities and traditional futures trades conducted on regulated exchanges, swaps dealers should be required to establish a self regulatory framework overseen by a federal regulator, including market surveillance, to ensure the safety and soundness of the trading system and to be the first line of defense against fraud

and manipulation by dealers in the swaps market.

9. *Clearing*. Again, as is true of the regulated securities and regulated futures infrastructure, a well capitalized and federally supervised intermediary should clear all trades as a protection against a lack of creditworthiness of, and default by, OTC derivatives counterparties.

The adoption of the traditional regulatory market protections for swaps would essentially return these markets to where they were as a matter of law prior to the passage of the CFMA in December 2000. The general template would be that swaps would have to be traded on a regulated exchange (which provides each of the protections outlined above). They would also have to be cleared by a well capitalized and regulated clearing facility unless the proponents of a risk shifting instrument demonstrate to the appropriate federal regulator that the instrument both on its own and as universally traded cannot cause systemic risk and will not lead to fraudulent or manipulative practices if traded outside an exchange and clearing environment. That is why the CFTC, in 1993, using exemptive authority provided to it by Congress, excused from exchange trading and clearing requirements swaps contracts not traded in standardized format, i.e., which are negotiated as to each of the instrument's material economic terms on a contract-by-contract basis.

Two further points should be emphasized:

Simple Clearing Is Not Enough. The financial services industry has argued vociferously that the requirement of clearing for OTC derivatives is all the regulation that is needed for these markets and that exchange trading should not be required. However, providing clearing only addresses one of the traditional regulatory protections outlined above: i.e., assuring the capital adequacy of counterparties (assuming that clearing facilities themselves will be properly regulated to ensure their own adequate capitalization). Capital adequacy is only one of the key requirements of traditional market regulation. With clearing alone, you do not have: (1) transparency as to pricing and the real parties in interest; (2) regulation of intermediaries for competency and prudential conduct; (3) self regulation to assist federal regulators in oversight; (4) record keeping and full documentation; (5) prohibitions on fraud and manipulation; (6) full disclosure to counterparties and to the federal government; (7) and meaningful private enforcement. Equities and traditional futures trading have this complete regulatory infrastructure built around the clearing process. And, we would never settle for clearing, and clearing alone, as a substitute for the full regulatory and self regulatory structure that surrounds, for example, the equities market. Yet, the dollar volume of OTC derivatives is far in excess of the equity markets and unregulated OTC instruments have repeatedly occasioned the threat and presence of systemic risk.

Clearing facilities themselves must be rigorously regulated. The CFTC's present regulatory scheme to approve clearing facilities requires the facility to meet highly generalized goals. It also allows the facility to begin operating upon filing of its application, rather than pre-approval by the CFTC. Moreover, the approval process is delegated to the CFTC staff rather than the Commission itself.

The mere existence of a clearing facility is not an automatic panacea to systemic risk. Five years ago, AIG might have convincingly advanced itself as financially sound enough to be a clearing institution. Similarly, an AAA entity that appears sound today may become unstable if the entire derivatives market is not adequately policed. In sum, the limited step of clearing by itself does not adequately protect against systemic risk. Given the great importance of approving a financially strong institution to clear these highly volatile and potentially toxic products, pre-approval of a clearing facility should be always required. It should also be required that the appropriate federal regulatory entity –not just the staff of that entity –issue affirmative and detailed findings about its confidence in the applicant serving as an OTC clearing facility. As Patrick Parkinson (then Deputy Director, Division of Research and Statistics of the Federal Reserve System) made clear in his November 20, 2008 testimony before Congress, the President's Working Group on Financial Markets is advising that OTC clearing facilities' qualifications be measured against the comprehensive "Recommendations for Central Counterparties" of the Committee on Payment and Settlement Systems of which Mr. Parkinson was the Co- Chair and on which the CFTC and SEC served.[16] Those comprehensive standards for clearing facilities should be included in any comprehensive regulatory reform legislation and federal overseers should issue detailed findings that the clearing facility meets those standards before clearing on that facility begins.

Pending Derivatives Legislation and Legislative Proposals

The Obama Administration White Paper

In response to the catastrophic systemic failure caused by unregulated derivatives, the Obama Administration in its June 2009 White Paper proposed that all standardized OTC derivatives be subject to clearing and exchange trading. It proposed that they be overseen in accordance with the traditional dictates of market regulation that had been in place since the New Deal and that were abandoned only in the deregulation of OTC derivative markets in 2000. The Administration also recommended that "[a]ll OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties should be subject to a robust and appropriate regime of prudential supervision and regulation,"[17] including the imposition of increased capital requirements, business conduct standards, and auditing requirements.[18]

The Administration further proposed that so-called "customized" derivatives may remain traded as over-the-counter products. The Administration acknowledged the potential for exploitation that differentiated derivative regulation entails, and sought to close any perceived "customization" loophole through greater oversight over dealers in customized products. Treasury Secretary Geithner had said that criteria he would employ to distinguish customized from standardized derivatives would be, by design, "difficult to evade."[19] CFTC

Chairman Gary Gensler also articulated a series of tests that would delineate standardized from customized instruments in a manner that would create a strong presumption that most of the existing OTC market would be deemed standardized and thus subject to exchange trading.[20]

In July 2009, a Blue Ribbon "Independent Task Force" composed of distinguished experts, i.e., the Investors' Working Group co-chaired by former SEC Chairmen Arthur Levitt, Jr. and William H. Donaldson, reached many of the same conclusions as are found in the Obama Administration White Paper on regulating OTC derivatives.[21]

The Treasury's OTC Derivatives Legislative Proposal

However, on August 11, 2009, the Treasury Department, on behalf of the Administration, submitted to Congress a specific legislative proposal (the "Proposed OTC Act") in furtherance of its prior narrative recommendations. The Proposed OTC Act created new and significant loopholes that would undermine the Obama Administration's stated goals for OTC derivative reform, namely, that the new regulatory structure "would cover the entire marketplace without exception."[22]

On August 17, 2009, CFTC Chairman Gary Gensler, in a letter to Congress, critiqued the following exclusions suggested by Secretary Geithner, but not previously found in the Obama Administration's narrative OTC reform proposals.

1. Foreign Exchange Swaps Exclusion. Chairman Gensler correctly explained: "The Proposed OTC Act would exclude foreign exchange swaps and foreign exchange forwards from the definition of a 'swap' regulated by the CFTC. The concern is that these broad exclusions could enable swap dealers and participants to structure swap transactions to come within these foreign exchange exclusions and thereby avoid regulation. . . .In short, these exceptions could swallow up the regulation that the Proposed OTC Act otherwise provides for currency and interest rate swaps."[23]

Chairmen Frank and Peterson, leaders of the two committees of jurisdiction on this legislation in the House of Representatives, challenged the wisdom of this exclusion, claiming that it would eliminate from the exchange trading and clearing requirements over $50 trillion in swaps.[24]

This kind of exclusion has proven highly problematical. Recently, we have discovered that Greece and Portugal, and possibly Italy and Japan (if not many others), have used, inter alia, foreign currency swaps sold by U.S. swaps dealers as a vehicle for masking short term sovereign debt in order to, inter alia, gain entrance to the European Union in exchange of the case of Greece for paying swaps dealers hundreds of billions of dollars in Greek revenue streams extending to the year 2019.[25] As one leading derivatives expert has noted, in these kinds of transactions, "the participant receives a payment today that is repaid by the higher-than-market payments in the future. . . Such arrangements provide

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funding for the sovereign borrower at significantly higher cost than traditional debt. The true cost to the borrower and profit to the [swaps dealer] is also not known, because of the absence of any requirement for detailed disclosure."[26]

2. Exceptions from Mandatory Clearing and Exchange Trading for Non-Banks. The Treasury's Proposed OTC Act included a further major and crippling loophole. As explained by Chairman Gensler, the Proposed OTC Act "creates an exception . . . from the mandatory clearing and trading requirements [if] one of the counterparties is not a swap dealer or major swap participant [(a non bank swap participant that does not present systemic financial risks.)] This excludes a major significant class of end users from the clearing and mandatory trading requirement."[27]

Thus, by its clear language, the general regulatory protections in the Treasury's Proposed OTC Act apply only to transactions between swaps dealers or between swaps dealers and other large institutions. As Chairman Gensler so correctly stated: "This major exception may undermine the policy objective[s] of lowering risk through bringing all standardized derivatives into centralized clearing . . . and increasing transparency and market efficiency though bringing standardized OTC derivatives onto exchanges . . . ."[28]

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Of course, the end user exemption theoretically was dealt with in the Obama White Paper by recognizing that truly customized agreements with end users would not be subject to exchange trading and clearing. By nevertheless including an end user exemption without reference to customization, the Treasury bill completely ended the standardization/customization dichotomy by acknowledging that even standardized end user agreements (which could be exchange traded and cleared) would now not be regulated. In this regard, the Treasury proposal is more deregulatory than the 2000 CFMA, which requires that in order to be deregulated, a swap must be "*subject to individual negotiation*."[29] Eliminating the "subject to negotiation" requirement in the CFMA of 2000 resolved pending litigation in favor of the swaps dealers and ISDA, whose practice of claiming that its mandatory standard, boilerplate and copyrighted Master Agreement for swaps was "subject to individual negotiation" had been challenged in court.[30]

3. Thwarting State and Private Regulatory Enforcement. The August 11, 2009 Treasury legislative proposal also recommended — without explanation — maintaining the 2000 CFMA's preemption of state gaming and anti-bucket shop regulation for unregulated OTC derivative products. As shown above, these OTC products are often marketed and used – not as hedging devices – but for pure speculation on future events. Since these instruments are unregulated on the federal level, states could (and should) readily view, for example, the purchase of a naked CDS guarantee on a CDO (which is in this case not owned by the "insured") as gambling on the non-payment of mortgages by subprime borrowers in violation of state gambling laws. Similarly, many swaps dealers market "bets" on the upward movement of physical commodities, such as energy and food products, where the counterparty gains if the products rise in price, but loses if the price goes down.[31] These commodity index swaps have been widely criticized as causing the huge upward price movement in physical commodities in defiance of market fundamentals. For example, Professor Nouriel Roubini describes the 2009 commodity spike as "money chasing commodities" and states that "[t]here is a risk that oil can rise to $80, $90 or $100 because of speculative demand,"[32] thereby likely breaking the back of any economic recovery from the debilitating recession caused by the subprime meltdown. Indeed, on March 24, 2009, 184 U.S. based and international human rights and hunger relief organizations sent a letter to President Obama urging the "re-regulat[ion of] the food and energy [swaps] to remove excessive speculation that has so clearly increased price volatility in the last few years."[33] Again, the preemption provisions within the 2000 CFMA and supported by the Treasury tie the states' hands at combating price distortions caused by betting on physical commodity prices.

In addition, the Treasury's proposed August 11, 2009 language clarifies an ambiguity in the 2000 CFMA, making it clear that neither a private party nor a state can seek to void an illegal swap in either state or federal court. Under this provision, if a swap does not satisfy the requirements of the federal law under which the swap is governed, it nevertheless cannot be invalidated nor can damages be awarded on that swap. This "anti-voiding" provision advocated by Treasury creates a perverse incentive for a swap dealer to completely ignore the laws that otherwise govern the swap. Moreover, the Treasury anti-voiding language once again resolved an ambiguity in the CFMA in favor of ISDA and the swaps dealers, which is now at the heart of ongoing litigation.[34]

H.R. 4173, Title III (The House Derivatives Bill)

On December 11, 2009, the House passed by a vote of 223-202 H.R. 4173 in which Title III addressed the regulation of derivatives. While this bill is quite long and intricate, in general contours it follows the August 11, 2009 Treasury legislative proposals insofar as it: (1) includes the foreign exchange swap and non-bank end users' exemptions – although upon joint agreement of the Treasury (which strongly supported the exemption) and the CFTC, the statutory foreign exchange swap exemption can be ended; (2) continues to preempt state gaming and anti-bucket shop laws for swaps that are not cleared and exchange traded; (3) ends the dichotomy between standardized and customized swaps, thereby ending the CFMA's requirement that swaps exempt from exchange trading must be "subject to individual negotiations" and allowing standardized swaps for the first time to evade exchange trading requirements; and (4) continues to provide that swaps not complying with the statute can, nevertheless, not be voided if counterparties meet minimal net worth requirements.

Three further deregulatory measures crept into the House bill:

1. Swaps Execution Facility. First, while the bill continues to require that swaps not otherwise exempt must be exchange traded, at the behest of Wall Street lobbyists, the exchange trading requirement can be satisfied by placement of a privately executed swap on a "swaps execution facility," which includes electronic trade execution or voice brokerage. While the electronic trade must be conducted by an entity "not controlled" by the counterparties, if the "SEF will not list the contract, it does not have to be executed."[25] In other words, the swap does not need to be exchange traded if it is submitted to a swaps execution facility that will not trade the swap. Pursuant to vigorous Wall Street lobbying, this SEF (introduced in House Agriculture Committee mark up) appears to undercut completely the bill's and the Obama Administration's exchange trading requirement.[36] The provision for the SEF must be removed from any bill addressing the regulation of derivatives and swaps.

2. Abusive Swaps. In Chairman Frank's discussion draft presented to the House Financial Services Committee markup, the legislation would have authorized the SEC and the CFTC to ban abusive swaps and then to jointly report such abuses to Congress.[37] As reported out of the House Financial Services Committee Markup and as passed by the full House, the provision simply provided that the CFTC and SEC could jointly report abusive swaps to Congress[38] – and deleted the authority to ban those swaps.

This substantial weakening of the "abusive swap" provision is quite significant. Even if the CFTC and SEC have the authority to enjoin swaps that are fraudulent and manipulative, the question may still arise whether those agencies can stop otherwise legitimate swaps that may not be fraudulent or manipulative but are destructive, nevertheless, to financial stability. The discussion above about CDSs and naked CDSs illustrates that those counterparties holding a CDS guarantee of a huge payout upon default of an instrument or an institution have an economic incentive to encourage the default. The classic case mentioned above is the holders of naked CDS guarantees who have bet that subprime mortgages will default have been accused of successfully lobbying against any legislation that would allow alteration of mortgage obligations to allow homeowners to stay in their homes. That conduct may not be fraudulent or manipulative. But it is highly abusive and federal regulators should have authority to ban that kind of destructive financial conduct – not simply "report" it to Congress.

Indeed, shortly after the House passed H.R. 4173, a further incident occurred that clearly demonstrated the need for federal regulators to ban abusive swaps. In order to avoid bankruptcy and the loss of 30,000 jobs, YRC Worldwide, Inc. ("YRC") attempted to have certain of its bondholders convert their debt status to equity in order to clean up the YRC balance sheet. YRC is the largest U.S. manufacturer of trucks. Shortly before the deadline for conversion on December 23, 2009, the Teamsters Union, representing the YRC workers, discovered that certain Wall Street interests were marketing a strategy to defeat this rescue effort. Those interests were marketing a financial package that included the sale of the bonds in question along with CDSs that would pay off upon the bankruptcy of YRC. To profit from the package, the investor holding the bond would vote against the bond/equity exchange, triggering the bankruptcy with an accompanying huge payout on the YRC CDS.

On December 22, 2009, Teamster President James Hoffa sent a letter to state regulators calling for an investigation of this highly damaging financial package and held a press conference denouncing the attempt to profit from the destruction of the fragile U.S. manufacturing base and 30,000 union jobs just as the U.S. was trying to fight its way out of the recession. The deadline for the bond conversion was extended to December 31, 2009. Upon being confronted by the strong Teamster reaction, several of the Wall Street marketers of this financial transaction switched their position (i.e., voted for the bond conversion) and the company was saved shortly before the New Year.[39] Several states are considering or have begun an investigation of this financial ruse.

Had the original House language authorizing the CFTC or SEC to ban abusive swaps been enacted into law, the YRC episode would have been a poster child for prompt federal action. As George Soros has recently said pertaining to the moral hazard associated with CDSs, "the market in credit default swaps . . . is biased in favor of those who speculate on failure. Being long on CDS, the risk automatically declines if they are wrong. This is the opposite of selling short stocks, where being wrong the risk automatically increases." [40]

3. Further Preemption of State Investor Protection Laws. It is ironic that the states, rather than the federal government, were willing to intervene to help the Teamsters Union defeat Wall Street's attempt to use, inter alia, CDSs to drive the nation's largest truck manufacturer into bankruptcy two days before Christmas. However, in addition to eliminating the CFTC's and the SEC's ability to ban abusive swaps, the House bill preempted state insurance laws as they apply to swaps.[41] (Again, the House and the Treasury also supported continuing the preemption of state gaming and anti-bucket shop laws as applied to swaps not traded on exchanges.) As mentioned above, CDSs have all the characteristics of insurance policies. The states have begun to aggressively pursue a model state insurance law that would require CDS, inter alia, to be capitalized adequately and to ban "naked" CDS as illegal insurance that insures the risks of other parties. With almost no explanation, shortly before the H.R. 4173 went to the floor, Chairmen Frank and Peterson introduced the insurance preemption into the bill over the express objection of state insurance officials, including the National Council of Insurance Legislators, which is drafting the model legislation.[42]

Not only should the preemption of state insurance laws be removed from the derivatives reform legislation, but the preemption of state gaming and anti-bucket shop laws for swaps that are not exchange traded must be ended as well. Senator Maria Cantwell has introduced legislation ending the gaming and bucket shops preemption.[43]

Senate Derivatives Legislation

As of this writing, neither of the two Senate committees of jurisdiction (Banking and Agriculture) has introduced legislation concerning the regulation of OTC derivatives. On November 10, 2009, Senate Banking Chairman Dodd introduced a discussion draft of a financial regulatory reform bill that for the most part followed the template of the U.S. Treasury legislative proposal on derivatives but greatly restricted the exemption from exchange trading for those derivatives needed by end users to hedge commercial risk.[44] After a hostile Republican reaction to the Dodd bill, the Chairman attempted to develop a bipartisan compromise. In recent days, it has been announced that a Senate Banking bill will emerge shortly – although it is unclear whether it will be fully bipartisan in nature.[45] If it is a bipartisan bill, the derivatives portion is expected to be much more deregulatory than the House bill or the original Dodd proposal, especially by expressly eliminating any requirement that a swap not subject to the foreign exchange or end user exemption will only have to be cleared and it will not have to be exchange traded. As of this writing, the Senate Agriculture Committee has not yet indicated the legislative direction it will take on this issue.

Conclusion

Unregulated OTC derivatives have been at the heart of systemic or near systemic collapses — from the 1995 bankruptcy of Orange County; to the collapse of Long Term Capital Management in 1998; to the bankruptcy of Enron in 2001-2002; to the subprime meltdown and resulting severe recession in 2008, and now to the emerging sovereign debt crisis in Europe. After each crisis, governments worldwide proclaim that the OTC market has to be regulated for transparency, capital adequacy, regulation of intermediaries, self regulation, and strong enforcement of fraud and manipulation. But, aided by the passage of time, Wall Street always deflates those aspirations with aggressive lobbying. The present financial reform regulatory effort may be the only chance to get this issue right before the country devolves into a further financial quagmire with more bankruptcies and more job losses. A review of the House's effort in this regard and present Senate proposals is not encouraging.

To avoid further systemic (and possibly irreparable) meltdowns, legislation must be enacted that:

1. Requires all standardized derivatives to be cleared by well-capitalized clearing facilities (to ensure capital adequacy and regularized marking to market of swaps). Legislation must require standardized derivatives to be traded on fully transparent and well regulated exchanges (to ensure price and trader transparency, regulation of intermediaries, self regulation, full disclosure and reporting (including having all derivatives "on balance sheet"). There must be strict anti-fraud and anti-manipulation requirements enforced by the federal government and the states, as well as private parties injured from such malpractices.
2. All swap dealers should meet strict capital and record keeping requirement, as well as business conduct rules.
3. Abusive swaps that are designed or marketed to cause economic injury and instability, e.g., forcing bankruptcies and unemployment, should be banned upon appropriate findings by the federal government.
4. There should be no federal preemption of state causes of action that

protect consumers and investors from derivatives transactions that are not cleared or exchange traded, including state insurance, fraud, gaming, and anti-bucket shop laws.

Endnotes

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