

COMMENTS

A SECOND CHANCE AT LEGAL CERTAINTY: AIG COLLAPSE PROVIDES IMPETUS TO REGULATE CREDIT DEFAULT SWAPS

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INTRODUCTION

During an August 2007 conference call, the Director and Executive Officer of American International Group Financial Products (AIGFP),¹

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1. American International Group Financial Products (AIGFP) is an independently

Joseph Cassano,² told AIGFP's clients, "It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing \$1 in any of those transactions."³ The transactions to which Mr. Cassano referred were over \$400 billion in credit default swaps (CDSs) that AIGFP sold to insure, among other things, securitized assets such as mortgage-backed securities.⁴ The above statement by Mr. Cassano suggests either a fundamental misunderstanding of the risks involved in AIGFP's CDS positions⁵ or a conscious attempt to mislead investors as to

operated, London-based financial services subsidiary of American International Group (AIG) principally engaged in the business of providing clients with "risk management solutions," including, among other activities, selling "credit default swaps to other financial institutions to protect against the default of certain securities." *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government-Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. (2009) (addendum to statement of Edward M. Liddy, Chairman & Chief Executive Officer, American International Group) [hereinafter *Liddy Addendum*], http://www.house.gov/apps/list/hearing/financialsvcs_dem/fsc_testimony_of_mr_edward_liddy.pdf.

2. Mr. Cassano, who joined AIGFP during its founding, ran the unit from early 2002 until February 2008 when he resigned amid precipitous declines in AIGFP's profitability. See Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Oct. 31, 2008, <http://online.wsj.com/article/SB122538449722784635.html> (describing the growth and ultimate decline of AIGFP's credit default swap (CDS) business during Mr. Cassano's tenure); Brady Dennis & Robert O'Harrow Jr., *A Crack in the System*, WASH. POST, Dec. 30, 2008, at A1 (noting that Mr. Cassano succeeded Tom Savage as the President of AIGFP in early 2002).

3. See Robert O'Harrow Jr. & Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1 (recounting the calm and confident demeanor with which Mr. Cassano gave this statement in response to a question about the stability of AIGFP's CDS portfolio).

4. See *Testimony Concerning Credit Default Swaps: Hearing Before the H. Comm. on Agriculture*, 110th Cong. (2008) (statement of Erik R. Sirri, Director, Division of Trading and Markets, United States Securities and Exchange Commission) [hereinafter *Sirri Testimony*] (placing the size of AIGFP's CDS portfolio at \$440 billion).

5. For most of its history, AIGFP engaged in painstaking quantitative risk modeling for every one of its transactions. A former AIGFP employee noted, "we're not going to do trades that we can't correctly model, value, provide hedges for and account for." Robert O'Harrow Jr. & Brady Dennis, *The Beautiful Machine*, WASH. POST, Dec. 29, 2008, at A1. Indeed, AIGFP's CDS models "suggested that the risk was so remote that the fees were almost free money." Dennis & O'Harrow, *supra* note 2. On this belief, AIGFP saw no need to hedge its huge CDS positions. See *id.* (noting that AIGFP considered the risk "so minute that hedging was considered unnecessary"). But the models overlooked two critical risks. First, they understated the risk AIGFP would have to settle the contracts by assuming that the housing market, to which many of the CDSs were connected by virtue of the fact that they insured mortgage-backed securities (MBS), could not fail to the degree that would cause the underlying assets to implode. See *id.* (reporting that AIGFP believed "the U.S. economy would have to disintegrate into a full-blown depression to trigger the succession of events that would require [AIGFP] to cover defaults"). Second, AIGFP overlooked counterparty risks by failing to consider, or fully appreciate, covenants in the CDS contracts addressing collateral. See Mollenkamp et al., *supra* note 2 (suggesting that AIGFP did not

their potential effect on AIGFP's bottom line.⁶

American International Group (AIG), the parent company of AIGFP, and the public at large are now acutely aware of the risks involved in these once-obscure financial products.⁷ Former Chief Executive Officer (CEO) and Chairman of the Board of AIG Edward M. Liddy cited as the root causes of AIG's downfall both the loss in value of AIGFP's CDS portfolio due to the deterioration of the residential mortgage market and collateral calls from counterparties after the major ratings agencies cut its once-sterling AAA credit rating, chiefly because of the dramatic loss in the value of its assets.⁸ Until 2008 when it predictably slowed, the CDS market grew rapidly during the late 1990s and early twenty-first century⁹ in the complete absence of regulatory oversight.¹⁰ Regulators and industry participants alike now agree that regulatory measures must be taken to bring some level of transparency to this perilously opaque market.¹¹

assign its principal risk modeler to assess the risk of collateral calls and "knew that his models didn't consider them").

6. See O'Harrow & Dennis, *supra* note 3 (noting that in late 2005, after becoming wary of the risks involved in its CDS operations, AIGFP stopped selling CDS protection, suggesting an understanding that they were not as safe as previously assumed).

7. See Mollenkamp et al., *supra* note 2 (noting that collateral calls on CDS contracts ate up most of the \$85 billion credit assistance fund created for AIG by the Federal Reserve Bank of New York on September 16, 2008, which was subsequently enlarged to \$123 billion less than a month later).

8. Liddy Addendum, *supra* note 1.

9. See GLEN TAKSLER ET AL., BANK OF AMERICA, CREDIT DEFAULT SWAP PRIMER 10 (4th ed. 2008) (noting that the International Swaps and Derivatives Association, Inc.'s (ISDA's) 2007 year-end survey estimated the outstanding notional value of CDS was \$62 trillion, up from less than \$8 trillion in 1997); see also Mark Brown, *OTC Contracts Shrank in Late '08*, WALL ST. J., May 19, 2009, <http://online.wsj.com/article/SB124268939601632389.html> (reporting that the volume of CDS contracts continued to decline in 2008 amid efforts to wind down offsetting contracts and that the notional value of outstanding CDS fell to \$41.9 trillion). The "notional amount" of a transaction is a dollar value used to calculate the final settlement amount under a contract. Because CDSs are privately negotiated contracts, the true value of the CDS market is difficult to estimate with precision. The notional value of the market may not accurately reflect the true credit exposure of the market because the ISDA's valuation only takes into account gross notional value. See TAKSLER, *supra*, at 4 (suggesting that the overall impact of CDS market size is probably much less than the \$62 trillion figure suggests).

10. See *Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008) (statement of Christopher Cox, Chairman, United States Securities and Exchange Commission) [hereinafter *Cox Testimony*] ("Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market.").

11. See *id.* (urging the Congress "to provide in statute the authority to regulate [CDSs] to enhance investor protection and ensure the operation of fair and orderly markets"); Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve, Stamp Lecture at the London School of Economics (Jan. 13, 2009), <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm> ("We must

This Comment addresses trends in the renewed focus on the regulation of over-the-counter (OTC) derivatives, using the CDS as a popular example and reference point. Part I of this Comment introduces the basic operation of a typical CDS, identifying primary uses and risks along the way. Part II discusses regulatory influences on the creation and growth of the CDS market. Part III outlines recent regulatory actions taken by the Securities and Exchange Commission (SEC) with regard to the CDS market, as well as ongoing industry initiatives undertaken in the United States and Europe, to bring order to the derivatives markets. Finally, Part IV concludes that Congress should grant primary regulatory authority over the CDS market to the Commodity Futures Trading Commission (CFTC) by amending the Commodity Exchange Act (CEA) and argues that the movement of certain CDSs onto regulated exchanges with associated clearing facilities would achieve regulatory objectives recently enumerated by the Obama Administration.

I. OPERATION OF A TYPICAL CDS

CDSs are bilateral, privately negotiated contracts used to transfer risk between two parties, “protection buyers” and “protection sellers.”¹² Buyers pay sellers annual premiums in exchange for a payout when a particular asset or entity, the reference entity, suffers one of a number of agreed upon, adverse credit events.¹³ The most common types of credit events include filing for bankruptcy, defaulting on a particular obligation, and restructuring or other equivalent bankruptcy protection.¹⁴ One innovation of the CDS is that the referenced credit may be an asset owned by an unrelated third party or it may be the third party itself.¹⁵ A CDS written on

continue our ongoing work to strengthen the financial infrastructure—for example, by encouraging the migration of trading in credit default swaps and other derivatives to central counterparties and exchanges.”); Liz Rappaport, *As SEC Steps Up Vigilance, It's Policing Some New Beats*, WALL ST. J., May 7, 2009, at C1 (“There is a clear political will in Congress and the White House to assert more oversight over [OTC] markets.”); Sarah N. Lynch & Serena Ng, *U.S. Moves to Regulate Derivatives Trade: Geithner Lays Out Plans of Framework for Multitrillion-Dollar Market; Agency Consolidation?*, WALL ST. J., May 14, 2009, at C1 (quoting Robert Pickel, chief executive of the International Swaps and Derivatives Association, stating that the government’s efforts to regulate CDSs and other OTC derivatives “is an important step toward much-needed reform of financial industry regulation”).

12. See TAKSLER ET AL., *supra* note 9, at 8 (providing a visual representation of a basic CDS contract).

13. See *id.* (noting that premium payments are also typically paid quarterly).

14. See *id.* at 15 (defining a credit event as “a circumstance that allows parties to trigger a CDS contract”).

15. See *id.* at 8 (demonstrating that this innovation provides more flexible investment opportunities than traditional funded investments in cash markets).

assets not owned or connected to the buyer is called a “naked CDS.”¹⁶ If a credit event occurs during the life of the contract, the protection buyer triggers the contract and settlement is effected.¹⁷ The protection seller retains all premium payments up to and including the date of the credit event.¹⁸ If no credit event occurs, the seller retains all premium payments in consideration for assuming the credit risk of the reference entity for the length of the contract.¹⁹

Like the price of stocks and bonds, the price of CDSs contains significant informational content because their price is a measure of the reference entity’s credit health.²⁰ A simplified pricing arrangement tracks the reference entity’s spread to the London Interbank Offered Rate (LIBOR).²¹ In a basic example, Buyer purchases a CDS from Seller with a \$10 million notional amount. Based on Buyer’s credit the spread is quoted in the contract at 380 basis points, or 3.8% above LIBOR. In this arrangement, Buyer will owe Seller \$380,000 per annum or \$95,000 quarterly.²² Although the parties to a CDS may elect otherwise, the industry’s widely used standard contract, the International Swaps and Derivatives Association’s (ISDA’s) Master Swap Agreement, allows for the periodic payments under most swap contracts, including CDSs, to be netted.²³

16. Naked CDSs are often criticized as mere speculative bets that actually create risk rather than hedge existing risks. See Sarah N. Lynch, *Bill Seeks Curbs on Derivatives*, WALL ST. J., May 15, 2009, <http://online.wsj.com/article/SB124239797854523981.html> (describing naked CDSs as “insurance-like contracts” in which buyers have no interest in, or risk exposure to, the underlying asset, thereby creating “moral hazard” by “incentivizing economic loss”).

17. TAKSLER ET AL., *supra* note 9, at 15; see also Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 176 (2007) (stating that the triggering of the contract is dependent only on the occurrence of a credit event and does not require any evidence of actual loss by the buyer).

18. See TAKSLER ET AL., *supra* note 9, at 18 (indicating that the market standard is for protection to begin the day after the contract date; if a credit event occurs on the same day the contract is executed there is no protection and no payment is due).

19. *Id.*

20. *Id.* at 26–27. Viewing the price of a CDS as the cost of insurance written on a company or other financial product such as a collateralized debt obligation (CDO), an increase in the cost of such a CDS might represent a perception of increased risk; the riskier the investment, the costlier the insurance.

21. See *id.* (describing a simplified pricing process as the reference entity’s spread to the London Interbank Offered Rate (LIBOR)). LIBOR is the rate at which the world’s most creditworthy international banks lend to one another. LIBOR is often used as a risk-free interest rate by which other rates are benchmarked. See BARRON’S DICTIONARY OF FINANCE AND INVESTMENT TERMS 396 (7th ed. 2006) (defining LIBOR).

22. See TAKSLER ET AL., *supra* note 9, at 26 (explaining that the reason price is calculated as a spread to LIBOR is due to the fact that buyers in the CDS market are assumed to fund at LIBOR).

23. PAUL C. HARDING, MASTERING THE ISDA MASTER AGREEMENT: A PRACTICAL

Although critical, pricing arrangements and contract details are only useful to the extent that they are available to market participants.²⁴ One recent commentator noted that the ISDA and the “principal market makers” often restrict access to information about contracts and counterparties, arguing that such information is proprietary.²⁵ Indeed, the handful of large banks that control most information regarding trades are reported to impede access to pricing information because it helps them maintain higher fees.²⁶ One journalist went so far as to declare, “Record keeping, documentation and other practices have been so sloppy that no firm could be sure how much risk it was taking or with whom it had a deal.”²⁷ If lenders, investors, and even the market generally have little way of knowing whether and to what extent a particular institution has hedged or traded part of its risk profile through the use of a CDS, they cannot adjust their own behavior in response.²⁸ In an efficient and transparent CDS market, signals like the widening of an entity’s CDS spread would alert investors and regulators to the possibility of increased risk taking.²⁹

Three principal uses of CDSs are as risk management tools, leveraged investments, and a means of increasing liquidity within an institution.³⁰

GUIDE FOR NEGOTIATORS 39 (2002) (“Payments can be made net if they are in the same currency, for the same Transaction and payable on the same date.”).

24. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1026 (2007) (observing that credit default swaps provide additional information to market participants when their pricing is publicly available).

25. *Id.* at 1026 n.16.

26. Cf. Serena Ng, *Banks Seek Role in Bid to Overhaul Derivatives*, WALL ST. J., May 29, 2009, at C1 (reporting that greater price transparency could reduce the standard gap between bid and offer prices on CDSs referencing corporate debt securities, creating a corresponding loss in the fees earned by major U.S. financial institutions dealing in swaps).

27. David Wessel, *Wall Street Is Cleaning Derivatives Mess*, WALL ST. J., Feb. 16, 2006, at A2.

28. See Partnoy & Skeel, *supra* note 24, at 1036 (“If suppliers, bondholders, or other stakeholders do not know whether [and to what extent] the bank is hedged, the informational content of the bank’s actions will be muddied.”).

29. The efficient market hypothesis argues that asset prices at any given point in time “reflect all relevant historical information” and “adjust rapidly in response to [new] information as soon as it becomes available.” EILÍS FERRAN, *PRINCIPLES OF CORPORATE FINANCE LAW* 75–76 (2008). Though pervasive in modern finance, this theory is not without its critics. See MICHAEL LEWIS, *LIAR’S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET* 221 (Penguin Books 1990) (1989) (noting that market innovators such as Michael Milken, the junk-bond king of Drexel Burnham, grew their success on the notion that markets, while efficient at digesting earnings data, are “grossly inefficient in valuing everything from the land a company owns to the pension fund it creates”); see also EDWARD CHANCELLOR, *DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION* 243 (2000) (noting that Warren Buffet once said, “observing correctly that the market was frequently efficient, [the efficient marketers] went on to conclude incorrectly that it was always efficient”).

30. See BILL WINTERS, *JP MORGAN CHASE & CO., DERIVATIVES* 3 (2009) (identifying these among four of the principal uses of derivatives at JP Morgan).

When used as risk management tools, CDSs can be employed to hedge against assets held by financial institutions. For example, when banks enter into a debt arrangement, say by purchasing corporate bonds, they assume credit risk.³¹ Suppose ABC Corporation issues \$100 million worth of bonds. Believing these bonds to be undervalued—that the market price overstates the credit risk—Bank A purchases all \$100 million. To hedge the credit risk, Bank A buys a CDS from Insurer B for the \$100 million face value of the bonds and for the same time that it takes the bonds to reach maturity. In this arrangement, Bank A is the protection buyer, Insurer B is the protection seller, ABC Corporation's bonds are the reference entity, and the notional value of the CDS is \$100 million.³² Pairing the purchase of a bond in the cash markets with a CDS referencing the bond can also be utilized in a strategy called a "basis package."³³ CDSs can even be used to hedge synthetic positions created by other CDSs.³⁴ Generally, CDSs offer an array of opportunities to diversify one's risk profile in ways not possible before their introduction into financial markets.³⁵ Indeed, CDSs are often credited with efficiently distributing risk

31. See Schwartz, *supra* note 17, at 174–75 (identifying credit risk as the risk that a bond issuer will default).

32. See Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 *FORDHAM L. REV.* 3095, 3097 n.13 (2008) (expounding on a similar example).

33. See Posting of Heidi N. Moore to Deal Journal, <http://blogs.wsj.com/deals/2009/05/04/the-brighter-side-of-evil-credit-default-swaps/> (May 4, 2009, 1:30 EST) (reporting that demand for this strategy led to increased demand for high-yield bond offerings). More specifically, the basis package or "basis trade" is an arbitrage strategy seeking to profit from mispricing in the cash and CDS markets. The example described above, whereby the trader goes long on the bond and buys a CDS referencing the bond, is generally done when the CDS price appears low and the bond spread high. The less common of these trades is a strategy called a "negative basis trade." See GREG N. GREGORIOU & CHRISTIAN HOPPE, *THE HANDBOOK OF CREDIT PORTFOLIO MANAGEMENT* 370–72 (2009) (describing basis trading strategies utilizing assets in the cash markets and their corresponding derivatives in synthetic markets).

34. CDS sellers can purchase offsetting CDSs to hedge their positions. This can occur on and on, ultimately involving numerous participants. In such a situation, each party may look only to its corresponding counterparty on a particular contract. Under normal conditions this arrangement works fine. But, if a triggering event occurs that renders any one party in the chain insolvent, discrepancies in notional amount, timing, or contract terms between the related contracts can create risks that spread throughout the chain, increasing systemic risk. See Partnoy & Skeel, *supra* note 24, at 1040 (identifying the systemic risk posed by a "vast array of interconnected contracts" in the CDS market and speculating that "even a relatively small market change could trigger a crisis of the sort that Long-Term Capital Management threatened to unleash when it collapsed in 1998"). This is particularly the case if a large number of CDSs are concentrated on particular participants. See Lily Tijoe, Note, *Credit Derivatives: Regulatory Challenges in an Exploding Industry*, 26 *ANN. REV. BANKING & FIN. L.* 387, 404 (2007) ("Ten of the top firms on Wall Street hold more than two-thirds of [CDSs].").

35. The basic idea behind risk management is diversification; if one asset fails, the holder is not ruined because its other, uncorrelated assets cushion the loss. The best kind of

in ways not seen before.³⁶

In their second application, derivatives create leverage by reducing the transaction costs of traditional cash instruments.³⁷ Specifically, CDSs allow investors to eliminate the need to purchase an underlying asset when they wish to take a position on the likelihood of default. Suppose an investor wanted to bet against a particular issue of mortgage-backed securities (MBSs). Traditionally, the investor would have to short the lower tranches of the securities. Now the investor can purchase a CDS and make the same bet more cheaply, without having to acquire the security itself.³⁸

Third, an institution may purchase CDS protection to leverage its own capital. For example, a bank might purchase a CDS referencing a large loan to a borrower to alleviate the need to syndicate the loan with competitors and reduce the risk associated with a default by the borrower.³⁹ The corresponding increase in liquidity and access to capital in the marketplace is often considered an important contribution of the CDS.⁴⁰

Like all other financial instruments, CDSs can be understood as bundles of different risks. Among other flavors, CDSs contain market risk,

diversification involves holding assets that are negatively correlated; when one asset declines in value, the others rise. For example, a bank holding a commercial loan to an oil company may hedge its exposure on the loan by purchasing a CDS from a third-party insurer referencing the loan and then by entering a second CDS, this time as the seller, on a portfolio of loans to automobile dealers held by another bank, which could be negatively correlated to the oil industry. If oil prices drop, the bank's risk on the loan to the oil company increases, but business for automobile dealers should be healthy and premium payments from the second bank will continue. See Peter J. Wallison, *Everything You Wanted to Know About Credit Default Swaps—But Were Never Told*, RGE MONITERS, Jan. 25, 2009, http://www.rgemonitor.com/globalmacro-monitor/255257/everything_you_wanted_to_know_about_credit_default_swaps--but_were_never_told (offering the above example and attempting to dispel myths about the CDS market, including the degree to which they increase systemic risk).

36. See Partnoy & Skeel, *supra* note 24, at 1024 (arguing that distributing risk is perhaps the most beneficial contribution to financial markets from the invention of the CDS).

37. See *supra* note 15 and accompanying text (noting that the reference credit may be owned by an unrelated third party). For example, an equity swap allows an investor to realize the gains of a certain amount of a particular stock without actually acquiring the stock itself. See ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* 102–03 (2000) (describing a standard equity swap transaction).

38. See Michael Lewis, *The End*, PORTFOLIO, Dec. 2008, <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom> (“The arrangement bore the same relation to actual finance as fantasy football bears to the N.F.L.”).

39. See Partnoy & Skeel, *supra* note 24, at 1023 (offering a more detailed explanation of the syndication example).

40. See *id.* at 1024–25 (identifying this advantage and comparing the benefit created to the advent of securitization on the credit markets).

counterparty risk, operational risk, and legal risk.⁴¹ Market risk is the risk that market events will have an adverse effect on asset values.⁴² For example, dramatic market movements in the value of MBSs, to which AIGFP's CDS portfolio was tied, caused a corresponding loss in the value of its CDS portfolio.⁴³ As with any derivative, a loss in the value of the underlying asset will cause corresponding, usually much greater, loss in the value of the derivative. Apart from concerns about the value of one's portfolio, market risk primarily presents itself in CDSs upon settlement of the contracts, when reference assets must be valued. Market risk is addressed in the ISDA's standard swap contracts by provisions allowing counterparties to select from a number of elective settlement and payment procedures.⁴⁴

Counterparty risk is the risk that a party to a swap contract will not be sufficiently liquid to meet its obligations under the contract.⁴⁵ Counterparty risk exposure in forward-type derivatives like CDSs⁴⁶ is "two-sided"; unlike option-type derivatives, both parties to a swap are exposed to counterparty risk.⁴⁷ Counterparty risk creates perhaps the greatest risk exposure under CDS transactions. Counterparties to a CDS are typically asked to post collateral to cover counterparty risk.⁴⁸ However, because they derive their value from an underlying asset, "there are usually large fluctuations in the value of a derivatives contract during its life," creating difficulty and complexity in collateral arrangements as collateral is posted and reposted throughout the life of the contract.⁴⁹ As one industry participant notes, "Although no one knows exactly how much collateral is required to effectively manage Counterparty risk, as of year-end 2007, ISDA estimates that there was approximately \$2.1 trillion in collateral in circulation, up from \$1.3 trillion in each of 2006 and 2005."⁵⁰ Lastly, it should be noted that the use of collateral "will not in general eliminate the credit risk of a counterparty."⁵¹ Indeed, it may introduce or add to other

41. See WINTERS, *supra* note 30, at 7 (identifying these four categories among the principal risks in JP Morgan's derivatives holdings).

42. *Id.* (defining market risk).

43. See *supra* text accompanying note 8 (noting the relationship between AIGFP's MBS and CDS portfolios).

44. For more on settlement and payment procedures, see generally Harding, *supra* note 23, at 82–99.

45. See WINTERS, *supra* note 30, at 7 (defining counterparty risk).

46. See *infra* note 132.

47. Dietmar Franzen, *Design of Master Agreements for OTC Derivatives*, in 494 LECTURE NOTES IN ECONOMICS AND MATHEMATICAL SYSTEMS 19 (2001).

48. For more on the specifics of collateral measurements and arrangements in the ISDA's master swap agreement, see generally *id.* at 25–27.

49. *Id.* at 19.

50. TAKSLER ET AL., *supra* note 9, at 5.

51. Franzen, *supra* note 47, at 28.

preexisting risks, such as liquidity risk.⁵² In AIG's case, as the housing market and the value of the assets its CDS portfolio insured deteriorated, provisions in its CDS contracts required it to post additional collateral to cover the increased likelihood that it would have to settle the contracts.⁵³ The contracts also required additional collateral when the ratings agencies cut its coveted AAA credit rating, potentially signaling decreased liquidity within AIG.⁵⁴

Operational risk, or documentation risk, is the risk that errors and omissions in documentation or processing backlogs will result in financial loss.⁵⁵ Massive growth in the OTC derivatives industry during the late 1990s and into the early twenty-first century quickly outpaced the development of operational infrastructure in the industry, leading to confirmation backlogs and operational errors.⁵⁶ In 2006, major OTC derivatives market participants employed collective action to streamline settlement and confirmation procedures to reduce the number of unconfirmed trades by 80%.⁵⁷ The ISDA Master Swap Agreement contains various provisions addressing operational procedures, document transfers, and governing contractual terms when inconsistencies appear among various documents evidencing CDS transactions.⁵⁸

Finally, legal risk is the risk that contract terms will be construed as ambiguous or unenforceable against a counterparty.⁵⁹ For example, something as essential as what qualifies as a credit event can be an issue of

52. See WINTERS, *supra* note 30, at 7 (noting that such risks include operational risk, credit risk of collateral issuer, custody risk, liquidity risk, or legal risk). Liquidity risk, the risk that a credit downgrade, counterparty default, or a mismatch in cash flows will reduce liquidity within an institution, can be thought of as a subset of counterparty risk; one firm's liquidity risk is another firm's counterparty risk. See *id.* (defining liquidity risk); see also *id.* at 23 (defining liquidity risk as the risk that an event such as a credit rating downgrade, as happened to AIG, or a mismatch in cash flows—perhaps between offsetting CDSs held by the same entity—would lessen JP Morgan's own liquidity).

53. See Liddy Addendum, *supra* note 1 (citing as root causes of AIG's liquidity crisis the loss in value of AIGFP's CDS portfolio due to the deteriorating housing market and collateral calls from its CDS counterparties after its AAA credit rating was cut amid dramatic losses in the value of its assets).

54. *Id.*

55. See WINTERS, *supra* note 30, at 7 (defining operational risk as the risk that processing errors or confirmation backlogs will result in loss).

56. See *id.* at 21 (discussing JP Morgan's operational risk metrics and noting that market volatility and the integration of Bear Stearns have increased operational pressures on JP Morgan).

57. See U.S. GOV'T ACCOUNTABILITY OFFICE, CREDIT DERIVATIVES: CONFIRMATION BACKLOGS INCREASED DEALERS' OPERATIONAL RISKS, BUT WERE SUCCESSFULLY ADDRESSED AFTER JOINT REGULATORY ACTION 10 (2007) [hereinafter GAO REPORT] (describing this industry effort undertaken with the help of federal regulators).

58. See generally HARDING, *supra* note 23, at 35, 50–51 (summarizing the obligations of parties under an ISDA Master Agreement).

59. See WINTERS, *supra* note 30, at 7 (defining legal risk).

dispute.⁶⁰ AIG's own Paris banking unit, Banque AIG, a subsidiary of AIGFP, is embroiled in a potential disaster demonstrating the necessity of predictability concerning what events allow counterparties to trigger or unwind contracts.⁶¹ Ambiguous contract terms can also lead to dangerous conflicts of interest between parties at settlement.⁶²

If parties to a CDS are not acutely aware of all risks and all contractual terms, as appears to have been the case with AIGFP, large amounts of counterparty or other risk can go unaccounted for or unhedged in a firm's risk assessment. CDSs have also been accused of increasing systemic risk by creating vast webs of interconnected counterparties⁶³ and possibly deepening the recent financial crisis.⁶⁴

A final risk attributed to the lack of a fully transparent and efficient CDS market is its vast potential for speculation,⁶⁵ manipulation,⁶⁶ and insider

60. See, e.g., *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, 375 F.3d 168, 177–78 (2d Cir. 2004) (attempting to determine whether a “voluntary debt exchange” constituted a credit event triggering a CDS that Eternity purchased from JP Morgan as a hedge against Argentinean government bonds).

61. See Liz Rappaport, Liam Plevin & Carrick Mollenkamp, *AIG Fights a Fire at Its Paris Unit*, WALL ST. J., Mar. 26, 2009, at C1 (reporting that the resignation of two of Banque AIG's top managers could trigger default on its derivatives contracts, including CDSs, under provisions in the contracts designed to protect counterparties after changes of control).

62. See Tijoe, *supra* note 34, at 407–08 (describing a case where the plaintiff alleged that Credit Suisse, the seller of a CDS the terms of which charged it with valuing the reference credit at settlement, inflated the market value of the assets to reduce the amount it owed the buyer).

63. See Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008) (defining systemic risk as the risk that an economic shock, such as a market or institutional failure, will trigger the failure of a web of markets or institutions, ultimately resulting in an increase in the cost of capital or a decrease in its availability, often evidenced by significant price volatility); cf. Partnoy & Skeel, *supra* note 24, at 1040 (acknowledging that connections among firms created by webs of interrelated CDS contracts increase systemic risk in the wake of an economic shock); Neil Shah, *EU Derivatives Revamp Plan Puts Bankers on Edge: Industry Players, Fearing Tough Restrictions, Point to Concessions Already Made; What's 'Standardized'?*, WALL ST. J., July 3–5, 2009, at C2 (noting an argument by a derivatives trader that if governments aim to reduce systemic risk by regulating CDSs and other OTC derivatives, it makes most sense to establish a single global clearing facility to act as a central counterparty); Rob Wells & Sarah N. Lynch, *Obama Wants SEC, CFTC to Police Derivatives*, WALL ST. J., June 18, 2009, <http://online.wsj.com/article/SB124520844404822287.html> (reporting that a chief goal of the Obama Administration's plan for revamped derivatives regulation is to “[prevent] activities in those markets from posing risk to the financial system,” a less artful way of describing systemic risk).

64. See Lynch & Ng, *supra* note 11 (noting that government efforts to retool financial regulation are “designed to address markets such as those for credit-default swaps, which many say exacerbated the financial crisis”); Sarah N. Lynch, *CFTC Chairman Details Derivatives Plan*, WALL ST. J., June 4, 2009, <http://online.wsj.com/article/SB124413756875885773.html> (stating that many believe large financial institutions created the recent credit crisis by using “exotic financial instruments like credit-default swaps to engage in reckless and risky trades”).

65. See Lewis, *supra* note 38 and accompanying text (“The arrangement bore the same

trading.⁶⁷ In a recent show of its antifraud authority over security-based swap agreements, the SEC brought an insider-trading action against a person alleged to have bought CDSs from a Dutch media company on material, nonpublic information obtained from a source at Deutsche Bank AG, who was in the process of structuring a debt offering on behalf of the company.⁶⁸

II. REGULATORY HISTORY

“Our financial system is fast-paced, enormously creative.”⁶⁹ Time and again, regulators craft rules to address emerging issues and new products are developed seemingly overnight to sidestep them.⁷⁰ The story of the CDS has been no different.

A. Development of the CDS

A group of bankers at JP Morgan executed the first CDS in 1994 when they developed a plan to sell the risk from large loans extended to Exxon in the wake of the Exxon Valdez oil spill. The plan was developed to allow JP Morgan to reduce the amount of regulatory capital needed to cover the

relation to actual finance as fantasy football bears to the N.F.L.”).

66. See Partnoy & Skeel, *supra* note 24, at 1034–35 (using the 2004 Chapter 11 filing of Tower Automotive to illustrate the incentive for lenders who purchase CDSs to hedge positions on their loans to “use the leverage afforded by its loan to force a default” and “affirmatively destroy value”). For more about the Tower Automotive incident, see Henny Sender, *Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play*, WALL ST. J., July 18, 2005, at C1 (discussing how some bankers believed that hedge funds that financed loans to Tower forced its default to cover short positions it used as hedges for the deal).

67. See Tijoe, *supra* note 34, at 413 (reporting that the credit derivatives markets are especially vulnerable to insider trading since the primary actors, large financial institutions, are buying and selling derivatives referencing companies to which they have loan exposures, granting them inside knowledge).

68. See Liz Rappaport, *Case Opens New Front on Insider Trading*, WALL ST. J., May 6, 2009, at C1 (describing how the investor purchased CDSs referencing the company before it became public information that the company would increase the size of the offering, thus taking on more debt and increasing the price of CDSs referencing it).

69. LOWENSTEIN, *supra* note 37, at 37 (quoting David. W. Mullins, former Vice Chairman of the U.S. Federal Reserve).

70. An elegant example is the total return equity swap, a precursor of the CDS. “Regulation T” is a Federal Reserve Board regulation that limits margin—the extension of credit from brokers toward the purchase of stocks. See Credit by Brokers and Dealers (Regulation T), 12 C.F.R. § 220.1 (2009) (stating that Regulation T imposes “initial margin requirements and payment rules on certain securities transactions”). An equity swap does an end run around Regulation T because there is no actual purchase of any stock; an investor merely swaps premium payments with a bank in exchange for the payment of the “total return” (any appreciation plus any dividend paid) on a certain amount of a specified equity. See LOWENSTEIN, *supra* note 37 (explaining such a transaction between the infamous hedge fund, Long-Term Capital Management and Swiss Bank).

risk of the loans.⁷¹ When banks purchase CDSs on held assets they are able to “diminish their Basel-dictated capital reserve requirements by unloading some of the risks on their balance sheets.”⁷² In addition to reducing regulatory capital, CDSs are utilized as a form of credit enhancement for asset-backed securities.⁷³ In 1998 JP Morgan created an early form of collateralized debt obligation (CDO), called the Broad Index Secured Trust Offering, or Bistro, and approached AIGFP with a proposal to have it write CDSs on the senior tranches of the structured deals as a form of credit enhancement, to reassure “skittish investors.”⁷⁴

At the time, rules implementing the Basel Accord of July 1988 governed capital requirements for U.S. banking institutions.⁷⁵ In July 1994, the Basel Committee amended the Accord through “Basel II,” allowing commercial banks to calculate capital requirements for derivative contracts using a measure it had previously been reluctant to permit because it would always “yield a smaller capital requirement for each transaction” than the method previously used.⁷⁶ Banks long sought permission to use the method finally endorsed under Basel II because the reduced credit risk, and therefore reduced capital requirements, allowed them to enter into a greater number of transactions with each of their counterparties.⁷⁷

Currently, under Basel II,⁷⁸ in determining appropriate capital levels, banks must take into account market, operational, and credit risks.⁷⁹

71. See John Lanchester, *Outsmarted: High Finance vs. Human Nature*, NEW YORKER, June 1, 2009, at 83, available at http://www.newyorker.com/arts/critics/books/2009/06/01/090601crbo_books_lanchester (reviewing a recent book discussing the creation of credit derivatives and CDSs).

72. Schwartz, *supra* note 17, at 175.

73. *Credit enhancement* is a term describing various strategies “used by debt issuers to raise the credit rating of their offering, and thereby lower their interest costs.” BARRON’S DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 21, at 152. In the modern CDO market CDSs are but one form of credit enhancement. Others include over-collateralization (putting more assets in the tranches than needed to pay the promised return to investors), bank letters of credit, or municipal bond insurance. See *id.* at 153.

74. Dennis & O’Harrow, *supra* note 2.

75. See Barbara C. Matthews, *Capital Adequacy, Netting, and Derivatives*, 2 STAN. J.L. BUS. & FIN. 167, 168 (1995) (explaining that the Basel Accord established “international minimum capital requirements to cover the credit risks of bank’s on- and off-balance-sheet activities”).

76. *Id.* at 171–72.

77. *Id.*

78. The United States adopted Basel II in 2007. See News Release, Administrator of National Banks, Office of the Comptroller of the Currency, OCC Approves Basel II Capital Rule (Nov. 1, 2007), <http://www.occ.gov/ftp/release/2007-123.htm> (announcing the approval of a final rule implementing the Basel II agreement); see also Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007) (codified at 12 C.F.R. pt. 325) (implementing the Basel II agreement).

79. See James A. Fanto, *The Role of Financial Regulation in Private Financial Firms: Risk Management and the Limitations of the Market Model*, 3 BROOK. J. CORP. FIN. & COM. L. 29, 40 n.74 (2008) (noting the implementation of the Basel II requirements and

However, risk assessments are conducted internally⁸⁰ and adequate guidance as to the calculation of credit risk is lacking.⁸¹ Indeed, financial institutions must incorporate credit derivative positions into their calculations of required risk-based capital levels,⁸² but they may also recognize the hedging effects of eligible CDSs on calculations of credit risk.⁸³

Recently, AIG disclosed in regulatory papers that it faces new risks from a portfolio of “regulatory capital super senior credit default swap[s]” written to provide “regulatory capital relief” for a number of financial institutions, mostly in Europe.⁸⁴ AIG also expects that most of the counterparties to these contracts will terminate the swaps as the transition from Basel I to Basel II continues, and the market for regulatory-capital-reducing derivatives diminishes.⁸⁵

B. The State of Regulatory Non-Authority

At the turn of the century the U.S. economy narrowly averted the Long-Term Capital Management (LTCM) debacle,⁸⁶ and Congress aimed to bring “legal certainty”⁸⁷ to the uncertain status of the market for OTC derivatives.⁸⁸ At the time, the CDS was a relatively new addition to the

identifying risks incorporated in capital calculations).

80. See *id.* at 39–40 (arguing that this internal assessment is an acknowledgement that federal banking regulators recognize they do not have the resources to design and implement specific risk models for institutions).

81. See *id.* at 40 n.74 (noting that while standards have been issued to assess market risk, banking regulators adopted only guidelines for assessing credit and operational risks).

82. André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the United States and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 179–80 (2000) (citing OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC 96-43, CREDIT DERIVATIVES: GUIDELINES FOR NAT’L BANKS, available at 1996 WL 479141, at *9).

83. See Capital Adequacy Guidelines for Banks: Internal-Ratings-Based and Advanced Measurement Approaches, 12 C.F.R. pt. 3 app. C (2009) (allowing for recognition of hedging activities in capital computation for eligible CDSs at Section 34).

84. David J. Reynolds, *AIG Signals More Losses on Derivatives Portfolio*, WALL ST. J., July 1, 2009, at M12.

85. *Id.*

86. A full discussion of the collapse of Long-Term Capital Management is beyond the scope of this Comment. For an in-depth account, see generally LOWENSTEIN, *supra* note 37 (recounting the rise and fall of John Merriwether’s prominent hedge fund, which was brought down quickly as a result of large derivatives positions creating massive leverage).

87. See John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1378 (2008) (identifying flexibility, legal certainty, and shared regulatory coordination as three key purposes of the Commodities Futures Modernization Act of 2000 (CFMA)).

88. See Joel Wattenbarger, CFTC Jurisdiction over OTC Derivatives 6–7 (May 7, 1999) (unpublished comment), <http://cyber.law.harvard.edu/rfi/papers/cftc.pdf>. (pointing out that a critical cause of the uncertainty about the regulatory status of the OTC derivatives markets is the fact that the term *futures contract* is not defined in the CEA, thus leaving the

panopoly of OTC derivatives.⁸⁹ For the CDS market, the Commodity Futures Modernization Act of 2000 (CFMA)⁹⁰ achieved this legal certainty by providing that nothing in the Commodity Exchange Act of 1936 (CEA)⁹¹ shall apply to swap agreements,⁹² provided they meet certain conditions.⁹³ Furthermore, swap agreements are exempt from the definition of *security* in both § 2A of the Securities Act of 1933 (Securities Act) and § 3A of the Securities Exchange Act of 1934 (Exchange Act).⁹⁴ Thus, CDSs are currently not subject to regulation by either the CFTC or SEC, except to the extent the SEC believes it maintains antifraud authority over security-based swap agreements.⁹⁵

The regulatory framework of the CFMA was premised upon the belief that the players in the OTC derivatives market were sophisticated enough to protect themselves and that unnecessary regulation would stifle the growth of the markets and the innovation of new financial products.⁹⁶ Furthermore, regulators believed that a robust credit derivatives market could reduce the effects of systemic shock by distributing risk throughout

CFTC and the OTC derivatives industry to argue over whether or not a particular derivative was a future for purposes of the CEA).

89. See *supra* notes 71–74 and accompanying text.

90. Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified as amended in scattered sections of 7 U.S.C.).

91. Pub. L. No. 74-675, 49 Stat. 1491 (1936) (codified as amended in scattered sections of 7 U.S.C.).

92. See 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION § 1.02[2][E] (successor ed. to PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, COMMODITIES REGULATION (3d ed. 2004)) (describing exemptions from regulation under the CEA enacted by the CFMA).

93. See Exemption of Swap Agreements, 17 C.F.R. § 35.2 (2009) (exempting swap agreements provided that (1) they are negotiated by eligible swap participants, (2) they are customized agreements, (3) the creditworthiness of a party subject to the agreement was a material consideration in determining the terms of the agreements, and (4) the agreement was executed OTC).

94. See 15 U.S.C. § 77b-1 (2006) (exempting security-based and non-security-based swap agreements from the definition of *security* in § 2(a)(1) of the Securities Act); 15 U.S.C. § 78c-1 (2006) (exempting security-based and non-security-based swap agreements from the definition of *security* in § 3(a)(10) of the Exchange Act).

95. See Wells & Lynch, *supra* note 63 (noting that although the CFMA prevents the SEC from directly regulating swaps it has some antifraud authority); *Sirri Testimony*, *supra* note 4 (“[T]he SEC clearly has antifraud jurisdiction over the CDS market . . .”).

96. See Lynch, *supra* note 87 (noting that a stated goal of the CFMA was to “promote innovation for futures and derivatives”). The assumption that market participants were sophisticated enough to protect themselves would prove to be a monumental mistake as many institutional managers probably never fully understood the risks. In the 2008 installment of his annual letter to shareholders, Warren Buffet cautioned that “recent events demonstrate that certain big-name CEOs (or former CEOs) at major financial institutions were simply incapable of managing a business with a huge, complex book of derivatives. Include Charlie and me in this hapless group” Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc., to the Shareholders of Berkshire Hathaway Inc. 17 (Feb. 27, 2009), <http://www.berkshirehathaway.com/letters/2008ltr.pdf> [hereinafter Buffet Letter].

the financial system.⁹⁷ Thus, the CDS market grew unfettered by any significant regulatory constraints and is regulated only to the extent that market participants are themselves regulated.⁹⁸ While banking regulators stepped in to fill the void to some degree, they “gently prodded the industry to lead its own initiatives” rather than imposing heavy-handed regulation.⁹⁹

III. RECENT REGULATORY AND INDUSTRY DEVELOPMENTS

On January 22, 2009, the SEC issued interim temporary rules exempting a narrow class of “eligible credit default swaps”¹⁰⁰ from certain provisions of the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939 (Trust Indenture Act)¹⁰¹ in order to facilitate the clearing and settlement of eligible CDSs by central counterparties.¹⁰² Securities Act Rule 239T¹⁰³ exempts eligible CDSs that are issued or cleared by a clearing agency registered as a clearing agency under § 17A of the Exchange Act, or that are exempt from such registration and are offered or sold to “eligible contract participants,” as defined in § 1(a)(12)(C) of the CEA¹⁰⁴ from the provisions of the Securities Act.¹⁰⁵ This exemption does not apply to the antifraud provisions contained in § 17(a)¹⁰⁶ of the Securities Act.¹⁰⁷ Exchange Act Rules 12a-10T¹⁰⁸ and 12h-1(h)T¹⁰⁹ exempt eligible CDSs from the registration requirements contained in §§ 12(a)¹¹⁰ and 12(g)¹¹¹ of

97. See Partnoy & Skeel, *supra* note 24, at 1024 (reporting that this was the view of Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve, at the time the CFMA was debated).

98. See GAO REPORT, *supra* note 57 (noting that while OTC credit derivatives “are not regulated, certain major market participants are”).

99. See Tijoe, *supra* note 34, at 397 (describing the approach taken by the banking regulators as one of pushing industry participants to identify and manage risks posed by credit derivatives independently).

100. See 17 C.F.R. § 230.239T(d) (2009) (defining eligible credit default swaps).

101. 15 U.S.C. §§ 77aaa–77bbbb (2006).

102. See Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps, 74 Fed. Reg. 3967, 3967 (Jan. 22, 2009) (codified at 17 C.F.R. pts. 230, 240, & 260) [hereinafter Counterparty Order] (announcing the adoption of temporary rules exempting eligible CDS from certain provisions of the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939).

103. Temporary Exemption for Eligible Credit Default Swaps, 17 C.F.R. § 230.239T (2009).

104. See 7 U.S.C. § 1a(12) (2006) (defining eligible contract participants).

105. 17 C.F.R. § 230.239T(a).

106. See 15 U.S.C. § 77q(a)–(b) (2006) (proscribing fraudulent interstate transactions).

107. 17 C.F.R. § 230.239T(b).

108. Temporary Exemption of Eligible Credit Default Swaps from Section 12(a) of the Act, 17 C.F.R. § 240.12a-10T (2009).

109. Exemptions from Registration Under Section 12(g) of the Act, 17 C.F.R. § 240.12h-1(h)T (2009).

110. See 15 U.S.C. § 78l(a) (2006) (prohibiting any transaction in any security on any national securities exchange for which registration is not effective).

the Exchange Act, respectively. Lastly, Trust Indenture Act Rule 4d-11T¹¹² exempts any eligible CDS from the Trust Indenture Act, “whether or not issued under an indenture . . . if offered and sold in reliance on Rule 239T.”¹¹³

The SEC also endeavored to temporarily exempt clearing agencies acting as central counterparties from the requirement to register under § 17A of the Exchange Act,¹¹⁴ exchanges effecting transactions in nonexcluded CDSs from the requirements of §§ 5¹¹⁵ and 6¹¹⁶ of the Exchange Act to register as national securities exchanges, and any broker or dealer effecting transactions on an exchange in nonexcluded CDSs from the requirements of § 5¹¹⁷ of the Exchange Act.¹¹⁸ The SEC undertook these actions to enable central counterparties and exchanges “to become operational while we gain useful experience with the CDS market and evaluate the public input, including comments, we receive on the temporary rules and exemptions.”¹¹⁹

All of the above-mentioned exemptions apply only to certain “non-excluded CDS[s].”¹²⁰ For all swap agreements that do not meet the definition of nonexcluded CDSs, the exclusion from the definition of security in Section 2A of the Securities Act and § 3A of the Exchange Act will continue to apply.¹²¹ All of these exemptions were also temporary and expired on September 25, 2009.¹²²

The derivatives industries in both the United States and Europe have also undertaken a number of their own developments to strengthen and clarify the OTC markets, perhaps in an attempt to head off aggressive regulation.¹²³ In one such measure, participants in both the U.S. and

111. *See id.* § 78l(g) (setting registration requirements and exemptions therefrom for issuers of securities).

112. Temporary Exemption for Eligible Credit Default Swaps Offered and Sold in Reliance on Securities Act of 1933 Rule 239T (§ 230.239T), 17 C.F.R. § 260.4d-11T (2009).

113. *Id.*

114. *See* 15 U.S.C. § 78q-1 (2006) (setting forth a national system for the clearance and settlement of securities transactions).

115. *See id.* § 78e (prohibiting transactions on unregistered securities exchanges).

116. *See id.* § 78f (setting registration requirements for national securities exchanges).

117. *See supra* note 115.

118. *See* Counterparty Order, *supra* note 102, at 3968 (discussing companion actions undertaken by the SEC to issue further exemptions to facilitate the use of exchanges for certain eligible CDS transactions).

119. *Id.*

120. *See id.* at 3969 (defining nonexcluded CDSs as a small subset of CDS transactions that the SEC believes are not exempted from its jurisdiction by the CFMA).

121. *Id.*

122. *See* 17 C.F.R. § 230.239T (2009); 17 C.F.R. § 240.12a-10T (2009); 17 C.F.R. § 240.12h-1(h)T (2009); 17 C.F.R. § 260.4d-11T (2009).

123. *See* Serena Ng, *Banks Seek Role in Bid to Overhaul Derivatives*, WALL ST. J., May

European markets have adopted new standardized contracts with streamlined legal and settlement provisions and have utilized fixed coupons to provide for greater ease in clearing and risk management.¹²⁴ In the United States, CME Group, Inc. and Citadel Investment Group, L.L.C. recently partnered “to create an electronic trading platform for [CDSs].”¹²⁵ The same partnership also formed a clearing facility that has gained approval from regulators but is reported to have gained little support from industry participants.¹²⁶ Furthermore, the “only operable U.S. clearinghouse for [CDSs],” ICE Trust, is apparently only offering membership to major Wall Street banking institutions.¹²⁷ In a recent letter to the president of the Federal Reserve Bank of New York and eleven other major regulatory authorities, a group of large banks and money managers in the United States committed themselves to expanding access to clearing facilities for their clients and to “level[ing] the playing field between dealers and investment firms” by creating a mechanism to resolve valuation disputes.¹²⁸ Generally, initiatives proposed by the industry seem to be in accord with those prioritized by the government; however, as industry measures they would be voluntary and lack the teeth of agency regulation.

IV. REGULATION MOVING FORWARD

The near collapse of AIG, like the fall of LTCM before it, brings a renewed focus to the use and abuse of OTC derivatives generally and CDSs in particular. As Congress mobilizes to craft a response to our latest economic shock, the Obama Administration identified four regulatory objectives: “(1) preventing activities in [OTC] markets from posing risk to

29, 2009, at C1 (describing an effort by a group of major banks and money managers to present a plan to lawmakers detailing how they plan to overhaul their own industry and speculating that Wall Street is trying to “pre-empt new laws that could drain a big source of banks’ profits”).

124. See Serena Ng, *New Terms Planned for European Credit Default Swaps*, WALL ST. J., Apr. 19, 2009, <http://online.wsj.com/article/Sb124000403639730191.html> (reporting the new plan to trade with fixed coupons in Europe and noting that North American dealers began a similar program earlier in the month of April). These newly standardized CDSs are generally trading with coupons of 0.25%, 1%, 5%, or 10%. A contract with a 1% coupon means that for every \$10 million notional value on the contract, the protection buyer must pay \$100,000 annually. *Id.*

125. Lynch & Ng, *supra* note 11.

126. See Serena Ng, *Friction on Swaps Response*, WALL ST. J., June 3, 2009, at M3 (reporting disagreement between large banks and money managers about how the industry should address changes to the OTC markets).

127. Kara Scannell & Sarah N. Lynch, *Gensler Says Derivatives-Dealer Oversight ‘Critical’ to Obama Plan*, WALL ST. J., June 26, 2009, <http://online.wsj.com/article/SB124594865220454879.html>.

128. Emily Barrett & Serena Ng, *Banks, Money Managers Make Derivatives Pitch*, WALL ST. J., June 3, 2009, at C4.

the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.”¹²⁹

The remainder of this Part first concludes that the CFTC is the most appropriate agency to take the lead in regulation of CDSs and other OTC derivatives, and then argues that while additional reform is inevitable the movement of certain CDSs from OTC markets onto regulated exchanges and clearing facilities is a critical step in achieving the above-referenced regulatory objectives.

A. SEC and CFTC Jurisdiction

There are traditionally two ways to sort authority over new financial products between the CFTC and the SEC. The first, definitional approach looks at the product and asks whether it meets the definition of a security or a future.¹³⁰ A second, functional approach looks at the economic substance of the product and asks whether the instrument is designed to raise and allocate capital (the SEC’s specialty), or to shift and manage risk (the CFTC’s specialty).¹³¹ For CDSs, the CFTC is the appropriate choice under both of these metrics.

Although the CEA does not define the term *futures contract*, swaps generally, and the CDS in particular, are based upon the economic function of the forward.¹³² Futures, in turn, are simply customized, exchange-traded forwards.¹³³ In forwards, as in CDSs, buyers and sellers have fixed, symmetrical obligations; the buyer agrees to pay a specified price at a future date, while the seller agrees to deliver an asset.¹³⁴ Furthermore,

129. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 47 (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter WHITE PAPER].

130. See Tijoe, *supra* note 34, at 394–95 (articulating that this is the traditional approach to allocating regulatory authority over new financial products, but noting that it is not particularly useful for innovative products like CDSs that defy easy classification).

131. See Wattenbarger, *supra* note 88, at 15 (referring to the position of former CFTC Chairperson Phillip Johnson that activities designed to shift or price risk are the regulatory responsibility of the CFTC).

132. See Tijoe, *supra* note 34, at 415 (concluding that credit derivatives are “byproducts of options and forwards,” and thus “more closely related to futures than securities”); see also BARRON’S DICTIONARY OF FINANCE AND INVESTMENT TERMS, *supra* note 21, at 270 (defining a forward as the purchase or sale of a financial instrument at the current price with delivery and settlement at a specified future date); Bernard J. Karol, *An Overview of Derivatives as Risk Management Tools*, 1 STAN. J.L. BUS. & FIN. 195, 196 (1994) (arguing that a swap is merely a type of customized forward).

133. Karol, *supra* note 132, at 196.

134. *Id.*

CDSs and forwards create similar, two-sided risk exposures.¹³⁵ Thus, under the definitional jurisdictional test, CDSs are more akin to futures than securities.¹³⁶

Under the functional test, CDSs again fall under the proper jurisdiction of the CFTC. Like options and futures, the basic economic utility of the CDS is as a risk management device to shift, price, or even acquire risk.¹³⁷

However, it appears that shared jurisdiction between the SEC and CFTC is the most likely result; this has been the result in previous turf wars between the two agencies and has been alluded to in statements by the Obama Administration.¹³⁸ As a counterpoint to CFTC jurisdiction, the case for SEC jurisdiction relies primarily on the reach of the SEC's antifraud authority¹³⁹ and the interconnections between the CDS and cash securities markets.¹⁴⁰ In a recent interview, SEC Chairman Mary Schapiro argued that security-based derivatives should be subject to the same regulatory regime as securities because they can operate as "substitute[s] for direct participation in the securities markets"¹⁴¹ While certain derivatives can be used to replicate physical positions in cash markets, the relationship is somewhat more attenuated with CDSs than with other derivatives such as equity swaps. The SEC Chairman most recently proposed to divide authority by giving oversight of security-based swaps to the SEC, while giving the CFTC authority to regulate foreign-exchange, interest rate, and commodity swaps.¹⁴²

There has been some discussion of combining the CFTC and SEC into a single regulatory body responsible for the financial system generally, but

135. See Franzen, *supra* note 47 (explaining that, unlike option-type derivatives, both parties to forward-type derivatives, such as swaps, are exposed to counterparty risk).

136. For an argument that CDSs do not meet the Supreme Court's *Howey* test for determining when a financial instrument or investment is a security, see Tijoe, *supra* note 34, at 396–97.

137. See Karol, *supra* note 132, at 196 ("Derivatives are generally a zero-sum game; they allocate risk rather than create wealth."). For a discussion of the basic operation, uses by market participants, and attendant risks of CDSs, see *supra* Part II.

138. See Wells & Lynch, *supra* note 63 (reporting that a recent proposal on financial regulation released by the Obama Administration appears to advocate coextensive jurisdiction yet fails to elaborate just how authority would be divided).

139. See *Cox Testimony*, *supra* note 10 (discussing an effort by the SEC's Enforcement Division to investigate institutions and broker-dealers with significant trading activity in CDSs on the basis of its antifraud authority); *Sirri Testimony*, *supra* note 4 ("[T]he SEC clearly has antifraud jurisdiction over the CDS market").

140. See *Sirri Testimony*, *supra* note 4 ("[W]e have seen CDS spreads move in tandem with falling stock prices, a correlation that suggests that activities in the OTC CDS market may in fact be spilling over into the cash securities markets.").

141. Kara Scannell, *Schapiro Supports Oversight of Derivatives*, WALL ST. J., June 18, 2009, <http://online.wsj.com/article/SB124527900030625009.html>; see also *supra* notes 37–38 and accompanying text.

142. Sarah N. Lynch, *Schapiro Says SEC Will Regulate Security-Based Swaps*, WALL ST. J., June 22, 2009, <http://online.wsj.com/article/SB124569756995038161.html>.

such arguments do not seem to have gained serious support in light of the political push back that would likely accompany such an effort.¹⁴³ Still other commentators argue for a self-regulatory model.¹⁴⁴ However, recent market events appear to have shifted the political winds against such an argument.¹⁴⁵ Because CDSs are statutorily exempted from the jurisdiction of the CFTC and SEC,¹⁴⁶ any turf war for authority must be settled by the stroke of a political pen. The CFTC is the most appropriate candidate for regulatory authority, but it will need significant additional resources to carry out effective oversight of the CDS market.¹⁴⁷

B. Key Regulatory Initiatives

The two primary regulatory initiatives coming to the CDS market are the movement onto regulated exchanges and the expanded use of clearing facilities to be used as central counterparties.¹⁴⁸ However, market participants, Congress, and the Executive Branch differ as to what level of regulation should be imposed. The industry advocates the creation of central counterparties for standard products and increased reporting for customized products¹⁴⁹ but believes that exchange trading and clearing should not be mandatory.¹⁵⁰ One proposed alternative is the imposition of “regulatory surcharges” on non-exchange-traded derivatives.¹⁵¹ Such

143. See Scannell, *supra* note 141 (noting that “[s]ome critics say the administration was too timid and should have merged the two agencies”). For an argument that combining the CFTC and SEC to form a single financial market regulator would be advantageous, see Lynch, *supra* note 87, at 1434–40.

144. See Lynch, *supra* note 87, at 1405–15 (arguing that an OTC derivatives industry initiative in 2006 to reduce the number of unconfirmed trades by 80% demonstrates the ability of market participants to self-regulate). *But see Cox Testimony, supra* note 10 (identifying the purely voluntary nature of the SEC’s now-defunct Consolidated Supervised Entity Program as a critical reason for its failure).

145. See *supra* note 11.

146. See *supra* Part III.B (discussing CFTC and SEC statutory authority with respect to derivatives).

147. See Gary Gensler, Nominee for Chairman, U.S. Commodity Futures Trading Commission, Testimony Before the Senate Comm. on Agriculture, Nutrition, and Forestry 2 (June 4, 2009), http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opa_gensler-3.pdf. (remarking that the CFTC needs “positive new authority” “to fulfill its mission”).

148. See Ian Talley, *Obama’s Pick for Commodity Post Vows New Era of Regulation*, WALL ST. J., Feb. 4, 2009, at A10 (reporting that Gary Gensler, President Obama’s nominee for Chairman of the CFTC, specifically stated that he would, if confirmed, oversee the movement of OTC derivatives onto regulated exchanges and clearing houses in response to written questions posed by lawmakers in anticipation of his nomination hearing).

149. See *supra* note 127 and accompanying text.

150. See Ng, *supra* note 123 (“Many bankers are against mandatory exchange-trading . . .”).

151. Charles W. Calomiris, *Opinion: Financial Reforms We Can All Agree On*, WALL

surcharges would allow the market to decide how many, and which, derivatives utilize exchanges and clearing facilities by imposing on institutions higher capital requirements for customized OTC derivatives that have not been cleared.¹⁵² On the opposite side of the spectrum, some members of Congress appear to be gunning for tough regulation, eliminating OTC markets and naked CDSs altogether.¹⁵³ Somewhere in between lies the Obama Administration, advocating a position that this Comment proposes is the soundest and most likely result—moving standardized CDSs to exchanges with mandatory use of clearing facilities, while still allowing custom OTC CDS trading for particularized purposes, subject to increased reporting and regulatory capital surcharges.¹⁵⁴

While the remainder of this Comment addresses how exchange trading and clearing facilities would benefit the CDS market, regulators are most likely to consider numerous other measures including reforming capital requirements and accounting standards,¹⁵⁵ business conduct standards,¹⁵⁶ developing a transparent electronic trading platform,¹⁵⁷ regulation of hedge funds and other nonbank intermediaries,¹⁵⁸ record keeping and reporting practices,¹⁵⁹ registration of derivatives dealers,¹⁶⁰ and aggregate speculative

St. J., Apr. 23, 2009, <http://online.wsj.com/articles/SB124044213684645481.html>.

152. *Id.*

153. Lynch, *supra* note 16.

154. See Lynch, *supra* note 64 (reporting that CFTC Chairman Gary Gensler's plan is to introduce exchange trading and clearing for standardized OTC derivatives while still allowing for OTC trading of some customized derivatives); Scannell & Lynch, *supra* note 127 (noting that Mr. Gensler indicated that custom OTC contracts should correspond to higher capital requirements than standardized contracts because they are "less liquid and less transparent"). Specifically, the Obama Administration proposes to contain systemic risk by amending the CEA to require that standardized OTC derivatives be cleared through regulated central counterparties which impose "robust" margin requirements, but still allow for the possibility of custom products, albeit with the imposition of regulatory surcharges. See WHITE PAPER, *supra* note 129, at 47 (noting that regulatory reform should ensure that "customized OTC derivatives are not used solely as a means to avoid using [central counterparties]"); *id.* at 48 ("[R]egulatory capital requirements on OTC derivatives that are not centrally cleared also should be increased for all banks and [bank holding companies].").

155. See WHITE PAPER, *supra* note 129, at 48 ("Key elements of [a] robust regulatory regime must include conservative capital requirements . . ."); Damian Paletta, *Geithner Wants New Rules to Check Risks*, WALL ST. J., Mar. 26, 2009, at A3 (reporting that Treasury Secretary Timothy Geithner is pushing for reform of financial accounting standards, regulatory capital levels, and risk-management standards as part of a general effort to reduce systemic risk in the U.S. economy).

156. See WHITE PAPER, *supra* note 129, at 48 (advocating the imposition of business conduct standards).

157. See *id.* (arguing that this measure is needed to increase market efficiency and transparency).

158. See *id.* (stating that Secretary Geithner is also calling for tighter controls on institutions like hedge funds). For more about hedge funds and the various loopholes that exempt them from regulation, see generally Wynkoop, *supra* note 32, at 3100–04.

159. See WHITE PAPER, *supra* note 129, at 48 (arguing that the CEA should be amended to allow the SEC and CFTC to impose record-keeping and reporting requirements

position limits on derivatives holdings.¹⁶¹

1. Movement onto Regulated Exchanges

The enactment of the CFMA brought about a “three-tiered” layering of commodities and derivatives regulation.¹⁶² The greatest degree of regulation takes place on the designated contract markets,¹⁶³ where retail futures trading occurs.¹⁶⁴ Efforts to bring CDSs into this top tier require removing their status as exempt transactions under the CEA¹⁶⁵ and including them in the ambit of transactions which must be executed “on or subject to the rules of a . . . contract market or derivatives transaction execution facility.”¹⁶⁶

Standardization of contract terms such as timing and choice of credit events is an important, though not necessary, step toward efficient exchange trading. Doing so would render CDSs more fungible for purposes of exchange trading.¹⁶⁷ Efforts to create standardized CDS

“consistent with their respective missions”); Buffet Letter, *supra* note 96 (“When I read the pages of ‘disclosure’ in 10-Ks of companies that are entangled with [derivatives], all I end up knowing is that I *don’t* know what is going on in their portfolios (and then I reach for some aspirin).”).

160. See Scannell & Lynch, *supra* note 127 (reporting that Chariman Gensler stated in an interview with the *Wall Street Journal* that “‘only through the dealer can we get the whole panoply’ of information about derivatives contracts.”).

161. See Lynch, *supra* note 64 (reporting that the Obama Administration’s plan for OTC derivatives includes position limits); WHITE PAPER, *supra* note 129, at 48 (arguing that position limits should be set on OTC derivatives that “perform or affect a significant price discovery function with respect to regulated markets”).

162. See JOHNSON & HAZEN, *supra* note 92, § 1.02[8][F], at 83–84 (describing the effect of the enactment of the CFMA on the regulation of the commodities markets).

163. *Id.* § 1.04[1], at 150 (defining *contract markets* as “a board of trade or other exchange that has achieved designation as such by the CFTC”). Though not all contract markets are exchanges, and not all exchanges are contract markets, this Comment will use the terms exchange and contract market interchangeably for the sake of simplicity.

164. See *id.* § 1.02[8][F], at 84 (explaining further that commodities not traded on contract markets are subject to less regulation, depending on the classification of the commodity as either “excluded,” “exempt,” or “agricultural”).

165. See 17 C.F.R. § 35.2 (2009) (exempting swap agreements from regulation under the CEA provided they are entered into by eligible swap participants, are customized agreements, the creditworthiness of a party subject to the contract was a material consideration in determining the terms of the agreement, and the agreement was not entered into and traded on or through a multilateral transaction facility).

166. 7 U.S.C. § 6(a) (2006) (prohibiting the trading of futures other than on boards of trade designated or registered as a contract market or derivatives transaction execution facility by the CFTC, subject to certain exemptions).

167. See JOHNSON & HAZEN, *supra* note 92, § 1.02[3], at 25 (noting that a “key feature” of futures contracts traded on contract markets is “their standardized, uniform terms” and stating that these terms are “not negotiable between the parties”); *id.* at 26 (explaining that contracts for future delivery of a commodity without customized terms are still considered futures contracts if there is an implied right of the parties to enter into offsetting contracts in lieu of physical delivery of the commodity).

contracts to facilitate exchange trading could be undertaken without substantial difficulty by referencing the ISDA's Master Swap Agreement.¹⁶⁸ Indeed, some standardization by market participants is already occurring.¹⁶⁹

The benefits of exchange trading in the CDS market include providing a "centralized market, standardized contract specifications, transparent quotations, and transaction reporting."¹⁷⁰ Furthermore, it protects the investing public by allowing "exchange subscribers to better assess market depth and liquidity and allow regulators to better surveil for violations" of antifraud laws.¹⁷¹ Indeed, registered contract markets and derivatives transaction execution facilities (DTEFs) are required to keep records of all activities for a period of five years for easy inspection by the CFTC.¹⁷² The availability of such records, providing for easier inspection and investigation by investors and regulators alike, should be a key goal of any effort to reform what is criticized as a dangerously opaque market. However, perhaps the most beneficial result of moving CDSs to the contract markets in terms of reducing systemic risk is the introduction of central clearing facilities and counterparties.

2. Central Clearing and Counterparties

If CDSs are traded on contract markets they will then be subject to the rule that "[t]ransactions on contract markets, DTEFs or exempt boards of trade must be cleared by a derivative clearing organization registered with the CFTC."¹⁷³ Use of derivative clearing organizations (DCOs) would improve the systemic and counterparty risk outlook of the CDS market in a

168. See ALASTAIR HUDSON, *THE LAW ON FINANCIAL DERIVATIVES* 82 (1996) (identifying the ISDA Master Agreement as the "rules of the game which the parties are to play, as those rules are understood by the market place"). For an example of an ISDA Master Agreement, see *id.* at 233.

169. See *supra* note 124 and accompanying text.

170. Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Sections 5 and 6 of the Exchange Act for Broker-Dealers and Exchanges Effecting Transactions in Credit Default Swaps, 74 Fed. Reg. 133, 135 (Jan. 2, 2009).

171. See *id.* (noting added investor protection among the benefits of allowing exchange trading for certain CDSs not excluded from the SEC's jurisdiction under the securities laws).

172. See 7 U.S.C. § 7(d)(17) (2006) (mandating that boards of trade designated as contract markets "shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years"); see also *id.* § 7a(d)(8) (applying to derivatives transaction execution facilities (DTEFs) the same record-keeping requirements that apply to designated contract markets).

173. JOHNSON & HAZEN, *supra* note 92, § 1.05[3][A], at 192; see also 7 U.S.C. § 7a-1 (2006) (setting registration requirements and outlining governing principals for derivatives clearing organizations).

number of ways.¹⁷⁴

First, contract markets utilize clearance facilities, either internally or through the use of outside DCOs, to match offsetting sides of transactions by substituting the clearing facility for the immediate counterparties to a particular contract.¹⁷⁵ The DCO becomes buyer to one side and seller to the other.¹⁷⁶ Trades are “cleared” in the sense that the DCO confirms the transaction by receiving acknowledgment from both sides of the trade and stepping in as the central counterparty.¹⁷⁷ The hub-and-spoke system created by this process facilitates “entry and exit from the market” by eliminating the need for counterparties to locate original buyers and sellers to liquidate positions¹⁷⁸ and can effectively reduce systemic risk.¹⁷⁹

Second, DCOs guarantee “the financial integrity of all . . . contracts that it has accepted.”¹⁸⁰ To protect themselves, DCOs often require daily margins from clearing members.¹⁸¹ Also, daily settlement by DCOs reduces operational risks in the CDS market by keeping a daily account of all open positions, paying and receiving funds as necessary.¹⁸²

Membership in a DCO is separate from membership in a contract market and is available only to contract market participants who meet minimum financial requirements “that are typically far higher than the financial standards expected of other contract market members.”¹⁸³ This vetting process is justified given the position DCOs take as financial guarantors of transactions executed by their members.¹⁸⁴ Lastly, rules developed by the contract markets specify that all trades must be submitted to the DCO for clearance.¹⁸⁵

174. See 7 U.S.C. § 1a(9) (2006) (defining *derivatives clearing organization*).

175. See JOHNSON & HAZEN, *supra* note 92, § 1.05[1], at 189–90 (describing the process of clearing).

176. See *id.* (explaining that the confirmation process consists of matching transaction reports submitted by derivative clearing organization (DCO) members to the DCO at the end of each trading day).

177. See *id.* (noting also if matches are not found for a particular trade, the DCO notifies the member and the transaction is held open until a match is identified).

178. *Id.* at 189.

179. Cf. Partnoy & Skeel, *supra* note 24, at 1040 (“The rush to unwind a vast array of interconnected contracts could create serious liquidity problems in the financial markets.”).

180. See JOHNSON & HAZEN, *supra* note 92, § 1.05[1], at 190 (explaining that when a DCO member’s default on its obligations under a transaction exceed its own resources, the obligation to satisfy the remaining portion of the default “devolves on the clearing house”).

181. *Id.*

182. See *id.* at 189 (noting that DCOs assess the value of open positions, notify members of gains or losses in the value of its positions, pay and receive funds, and notify and collect collateral calls, all on a daily basis).

183. *Id.* at 190.

184. See *id.* (noting that these requirements are typically in the form of capital standards).

185. See *id.* (explaining that members of contract markets who are not also members of internal or external clearing facilities meet this requirement by tendering their trades to

The enactment of the CFMA paved the way for the registration of independent DCOs capable of clearing transactions on multiple contract markets.¹⁸⁶ DCOs operated within contract markets are subject to the same requirements applying to contract markets under the CEA.¹⁸⁷ Independent DCOs must comply with a set of thirteen “core principles” specified by the CFMA, which include maintaining adequate financial resources, risk management, and reporting and record-keeping requirements.¹⁸⁸

CONCLUSION

Though some argue that the CDS market actually functioned rather well during the economic downturn,¹⁸⁹ it is at least in part because the U.S. government backstopped AIG and is helping it to unwind its positions in an orderly fashion.¹⁹⁰ Even if such arguments are true, regulatory reform is still justified by the need to prevent systemically important firms like AIG from taking on risk in amounts that can cause disruptions in the broader economy, as well as the need to keep watch for fraud and manipulation.¹⁹¹ Further, if the government is to step in and clean up the moral hazard mess it should have the privilege of regulating. AIG’s near-death experience provides Congress an opportunity to reconsider what type of legal certainty is preferable in the OTC derivatives markets: certainty created by regulatory exemption, or by responsible, evenhanded regulation. This process should include careful discussion of the often-misunderstood CDS,

members of the clearing house, who then submit them for clearance, sometimes for a fee).

186. *See id.* (observing also that the CFMA acknowledged DCOs as separately regulated entities under the CEA and holds them to all requirements imposed on other “registered entities”).

187. *See id.* § 1.05[2], at 191 (identifying the statutory duties of DCOs).

188. *See id.* § 1.05[3][B], at 193-94 (listing the thirteen core principals applicable to DCOs, as added to the CEA by the CFMA); *see also* 7 U.S.C. § 7a-1(c)(2)(A) (2006) (“To be registered and to maintain registration as a [DCO], an applicant shall demonstrate to the Commission that the applicant complies with the core principles specified in this paragraph.”).

189. For such an argument, see Colin Barr, *The Truth About Credit Default Swaps*, CNNMONEY.COM, Mar. 16, 2009, <http://money.cnn.com/2009/03/16/markets/cds.bear.fortune/index.htm?postversion=2009031607>.

190. *See* Hugh Son, *With Fed’s Help, AIG Unloads \$16 Billion in Credit Default Swaps*, WASH. POST, Dec. 25, 2008, at D2 (describing AIG’s use of funds from the Federal Reserve Bank of New York to aid in winding down outstanding CDSs); *see also* Randall Smith, Jonathan Weisman & Liam Plevin, *Some at AIG Buck Efforts to Give Back Bonus Pay*, WALL ST. J., Mar. 26, 2009, at C1 (noting that as of March 14, 2009, AIG had retired 36% of its derivatives portfolio, while an estimated \$1.6 trillion in derivatives instruments remained).

191. *See* Barr, *supra* note 189 (arguing that “substantial reforms are still necessary” while presenting an argument that the CDS market performed better than expected during the financial crisis and that regulators overestimated the amount of risk posed by the market).

its role in the markets, and its principal risks. Though a shared role in regulating OTC derivatives between the SEC and CFTC is likely, the CFTC should be given primary authority over the CDS market because the CDS more closely resembles instruments traditionally within the CFTC's jurisdiction, such as forwards, in economic substance and function.

In crafting appropriate regulation, it will be important for authorities to remember that CDSs are not inherently evil or dangerous. When used prudently and effectively they are useful financial innovations that benefit both Wall Street and "Main Street" firms alike, allowing them to hedge risks that would otherwise be left unhedged.¹⁹² Too much or overly aggressive regulation will stifle a competitive market for derivatives, leaving them out of reach of smaller firms.¹⁹³ It is for this reason that a balanced approach is needed. Efforts should be made to facilitate more exchange trading and clearing of standardized derivatives. However, an OTC market for custom derivatives tailored to unique business operations should be allowed to continue subject to increased reporting and registration requirements and regulatory capital surcharges.

192. See René M. Stulz, Op-Ed., *In Defense of Derivatives and How to Regulate Them*, WALL ST. J., Apr. 7, 2009, <http://online.wsj.com/article/SB123906100164095047.html> (arguing that derivatives have beneficial uses for even small "Main Street" firms because they reduce the transactions costs of traditional risk management strategies).

193. *Id.*