RE-REGULATING "FINANCIAL WEAPONS OF MASS DESTRUCTION,"[1] OBSERVATIONS ON REPEALING THE COMMODITY FUTURES MODERNIZATION ACT AND FUTURE DERIVATIVE REGULATION

WILLIAM SPENCER TOPHAM*

I. INTRODUCTION

Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.[2]

During the last forty years, a pair of theories dominated financial and economic policy. The "Efficient Market" hypothesis holds that asset prices reflect all information available in the market, while the "Capital Asset Pricing Model" assumes that every investor rationally balances risk against reward. The resulting economic theory, legislation, and financial industry lobbying efforts consistently pushed towards financial deregulation, reaching a crescendo in 1999-2000 with the repeal of the Glass-Steagall Act[3] ("*Glass-Steagall*") and the creation of the Commodity Futures Modernization Act of 2000[4] ("*CFMA*"). During 2002, in a portentous statement issued in the Berkshire Hathaway annual report, famed investor Warren Buffet observed:

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number

* Associate Attorney, Callister Nebeker & McCullough, Salt Lake City, Utah.

1. WARREN E. BUFFET, BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 15 (2002), *available at* http://www.berkshirehathaway.com/2002ar/2002ar.pdf.

2. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 159 (1936).

3. Pub. L. No. 73-66, 48 Stat. 162 (1933), *repealed by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1138, 1341 (2001).

4. Pub. L. No. 106-554, 114 Stat. 2763 (2000).

until some event makes their toxicity clear. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. In my view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.[5]

In the shadow of the financial crisis of 2008 ("*Crisis*"), these theories have proven gravely false,[6] ushering in nearly cataclysmic economic consequences. Alan Greenspan, the former chairman of the Federal Reserve and noted free market proponent, admitted that a basic premise of the free market (that firms have the enlightened self-interest to monitor their own risk exposure) failed.[7]

Although the scope of the destruction levied on the U.S. economy by financial derivative contracts ("*Derivatives*") is still being assessed, the general consensus trends heavily towards viewing those instruments as a cornerstone of the Crisis.[8] The vastly unregulated market grew tremendously from 2001-2007, fueling the real estate asset bubble (and its eventual explosion) by multiplying systemic risk in the financial system.[9] The market toxicity of many exotic Derivatives is highly substantiated; however, the legislative response in the wake of the Crisis has been lackluster. Compounding the issue is the realization that time passage will further dampen efforts to realize regulatory reform. This article argues that a future of effective financial regulation must include a repeal of the CFMA coupled with new Derivative

5. BUFFETT, *supra* note 1.

6. *See generally* Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES MAGAZINE, Sept. 2, 2009, at MM36, *available at* http://www.nytimes.com/2009/09/06/magazine/06Economic-t.html?_r=2&pagewanted=1&sq=how%20economists%20got%20it&st=cse&scp=1.

7. Kristina Cooke, *Recession will be worst since 1930's: Greenspan*, REUTERS, Feb.18, 2009, http://www.reuters.com/article/newsOne/idUSTRE51H0OX20090218.

8. *See* William Greider, *The Money Man's Best Friend*, THE NATION MAGAZINE, Nov. 30, 2009, at 22, *available at* http://www.thenation.com/article/money-mans-best-friend.http://www.thenation.com/doc/20091130/greiderhttp://www.thenation.com/doc/20091130/greider

9. *Id. See also* John Kiff et al, *Credit Derivatives: Systemic Risks and Policy Options* 3 (Int'l Monetary Fund, Working Paper No. 09/254, 2009) *available at* http://www.imf.org/external/pubs/ft/wp/2009/wp09254.pdf ("The aggregate gross notional amount of outstanding credit derivative contracts rose from about $4 trillion at year-end 2003 to just over $60 trillion at year-end 2007.").

regulations (such as centralized clearing and exchange trading in certain cases) to achieve total transparency for Derivative markets. Particularly, changes are necessary to eradicate numerous loopholes in current Derivative legislation.

II. THE ROLE OF FINANCIAL DERIVATIVES IN THE CRISIS

"It sounds to me like selling a car with faulty brakes, and then selling an insurance policy on those cars."[10] That analogy, articulated by Phil Angelides during the first public hearing of the Financial Crisis Inquiry Commission, succinctly encapsulates the rationale behind many complex Derivatives such as credit default swaps ("*CDS*") and similar instruments such as collateralized debt obligations ("*CDO*") that assisted in the near collapse of the U.S. financial system. Although many factors contributed to the Crisis, including an emasculation of the Glass-Steagall Act, an inflow of cheap money from Asia,[11] and the rise of hedge funds and private equity,[12] the ability of financial firms to employ extreme investment leverage ("*leverage*") and spread the contagion systemically remains a central issue in financial post mortem analysis.[13] A thorough treatment of Derivatives could occupy tomes, and is thus beyond the scope of this article; however, a basic examination of several aspects (such as leverage and systemic risk) that heavily contributed to the Crisis follows to provide necessary background information.

10. *The official Transcript, First Public Hearing of the Financial Crisis Inquiry Comm'n* 30 (2010) (statement of Phil Angelides, Chairman Financial Crisis Inquiry Comm'n), *available at* http://www.fcic.gov/hearings/pdfs/2010-0113-Transcript.pdf.

11. Paul Krugman, *An Irish Mirror*, N.Y. TIMES, March 8, 2010, at A23, *available at* http://www.nytimes.com/2010/03/08/opinion/08krugman.html?em (discussing the Crisis parallels between the U.S. and Ireland, noting "[s]econd, there was a huge inflow of cheap money. In America's case, much of the cheap money came from China; in Ireland's case, it came mainly from the rest of the euro zone, where Germany became a gigantic capital exporter.").

12. *See* Cyrus Sanati, *Yearning for Glass-Steagall on Capitol Hill*, N.Y. TIMES DEALBOOK BLOG (Jan. 22, 2010, 3:17 PM), http://dealbook.blogs.nytimes.com/2010/01/22/yearning-for-glass-steagall-on-capitol-hill/.

13. *See* Colin Barr, *How It Got This Bad,* CNNMONEY.COM, Sept. 28, 2008, http://money.cnn.com/2008/09/26/news/leverage.fortune/index.htm.

A. An Overview of Derivatives

Derivatives are financial contracts that allocate risk from one investor to another, generally not involving a transfer of principal or title.[14] Misunderstood by the public, Derivatives and the corollary Wall Street bonuses have become easy scapegoats for the Crisis, directing incendiary populist rage toward the financial sector.[15] Contrary to current popular opinion, Derivatives have existed for thousands of years[16] and do play a useful role in hedging risk, particularly interest rate fluctuations.[17] For example, when used responsibly, interest rate swaps and currency swaps can help governments and firms balance variations in borrowing costs by keeping interest rates or currency rates homogenous.[18] Common Derivative varieties include futures, forwards, options, and swaps.[19]

While Derivatives do provide economic benefits, the list of disasters directly or indirectly caused by these instruments continues to grow: Long Term Capital Management, Sumitomo Bank, Barings Bank, Enron and countless other financial and non-

14. *See* DARELL DUFFIE, HOW SHOULD WE REGULATE DERIVATIVE MARKETS? 2 (2009), *available at* http://www.scribd.com/doc/19085996/Pew-Duffie-Derivatives.

15. *See, e.g.,* Adam Nagourney, *Bracing for a Backlash Over Wall Street Bailouts,* N.Y. TIMES, Mar. 16, 2009 at A1, *available at* http://www.nytimes.com/2009/03/16/us/politics/16assess.html (reporting on populist backlash over Wall Street bailouts, noting that "[t]he Obama administration is increasingly concerned about a populist backlash against banks and Wall Street, worried that anger at financial institutions could also end up being directed at Congress and the White House and could complicate President Obama's agenda.").

16. RANDALL DODD, FINANCIAL POLICY FORUM DERIVATIVE STUDY CENTER, DERIVATIVES MARKETS: SOURCES OF VULNERABILITY IN U.S. FINANCIAL MARKETS 1 (rev. 2004), *available at* http://www.financialpolicy.org/fpfspr8.pdf ("Derivatives have played a role in commerce and finance for thousands of years. The first known instance of derivatives trading dates to 2000 B.C. when merchants, in what is now called Bahrain Island in the Arab Gulf, made consignment transactions for goods to be sold in India.").

17. *See* Anurag Gupta and Marti G. Subrahmanyam, *Pricing and Hedging Interest Rate Options: Evidence from Cap--Floor Markets*, 29 JOURNAL OF BANKING AND FINANCE 701, 702 (2005), *available at* http://pages.stern.nyu.edu/~msubrahm/papers/Cap_paper.pdf.

18. *See* DODD, *supra* note 16, at 1–2.

19. *See* Stephanie E. Cucuru, *U.S. Cross-Border Derivatives Data: A User's Guide*, 93 FEDERAL RESERVE BULLETIN A1, A2 (2007), *available at* http://www.federalreserve.gov/pubs/bulletin/2007/pdf/crossborder.pdf.

financial firms have failed under the weight of Derivatives on their books.[20] Although some Derivatives trade on exchanges, most notably the Chicago Mercantile Exchange, current estimates place more than 59% of the Derivative market in over the counter ("*OTC*") transactions that encounter little regulation on pricing or clearing.[21] Derivatives are measured in "notional amounts" that reflect the market value of the underlying asset the derivative contract is based on, and current estimates place global outstanding notational amounts at $1,000 trillion.[22] That number represents the outstanding value on the underlying assets, and in many situations, the actual risk may be less.

In any event, the enduring question is how such an incomprehensible financial value has been, and remains, largely unregulated. One explanation lies in the accounting identity of many Derivatives: one party holds a positive market value on a Derivative while the opposing party holds the same amount in negative market value, thus cancelling each other out for accounting identity purposes.[23] For example, in a credit Derivative, such as a CDS contract (an instrument that functions as insurance against the default of a particular asset), CDS dealers are generally counterparties to other dealers, creating a daisy chain of systemic risk throughout the financial system.[24] Furthermore, CDO's generally comprise asset-backed securities, where the investment return is backed by payments on a particular debt obligation or packages of debt obligations, such as the mortgage obligations underlying the Crisis.[25] Aside from the risk associated with default of the underlying asset, "CDO squared" transactions create CDO's in which the underlying assets are "tranches"

20. *See* DODD, *supra* note 16, at 2–3 ("[L]ong-Term Capital Management collapsed with $1.4 trillion in derivatives on their books . . . [S]umitomo Bank in Japan used derivatives in their manipulation of the global copper market in the mid-1990s . . . [B]arings Bank, one of the oldest in Europe, was quickly brought to bankruptcy by over a billion dollars in losses from derivatives trading . . . [D]erivatives dealer Enron collapsed in 2001 – the large bankruptcy in U.S. history at the time – and caused collateral damage throughout the energy sector.").

21. *See* DUFFIE, *supra* note 14, at 2–3.

22. *Id.* at 2.

23. *Id.* at *3*.

24. *See id.* at 5.

25. *See id.*

(simply, bundled portfolios) of other CDO's.[26] The risk of either instrument is amplified when multiple levels of Derivatives are used—*i.e.*, CDS's used to insure CDO's and CDO's squared—a now notorious transaction that heavily contributed to the insurer side of the Crisis.[27] On the investment banking side, the failures of Lehman Brothers and Bear Stearns resulted from a run on their over the counter ("*OTC*") Derivative counterparties.[28] Moreover, in the accounting sphere, Derivatives can enable governments and firms to obtain financing without adding liabilities to their balance sheets, as demonstrated in the latest European debt crisis.[29]

Another explanation relates to the influx of "quants" into finance during the last several decades.[30] These math and physics PHD holders created increasingly complex mathematical models to circumvent the minimal regulations placed on Derivatives under the CFMA.[31] As a testament to the power of that shift in human capital, a strong relationship exists between the explosion of Derivatives between 2001 and 2007 and the creation of the "Gaussian Copula" function. The Gaussian formula assessed the

26. Michiko Whetten & Mark Adelson, *CDOs-Squared Demystified*, NOMURA FIXED INCOME RESEARCH (Feb. 4, 2005), http://www.securitization.net/pdf/Nomura/CDO-Squared_4Feb05.pdfhttp://www.securitization.net/pdf/Nomura/CDO-Squared_4Feb05.pdfhttp://www.securitization.net/pdf/Nomura/CDO-Squared_4Feb05.pdf.

27. *See generally* Michael Lewis, *The End of Wall Street's Boom*, PORTFOLIO.COM (Nov. 11, 2008), http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets Boom/index3.html.

28. *See* DUFFIE, *supra* note 14, at 6–7 ("Bear Stearns' OTC derivatives counterparties reduced their exposures to Bear Stearns as news of its weakness spread. As they moved their derivatives positions to other dealers, they withdrew the cash collateral they had posted with Bear Stearns, reducing Bear Stearns' liquidity and accelerating its failure.").

29. *See* Louise Story, Landon Thomas Jr. & Nelson D. Schwartz, *Wall St. Helped to Mask Debt Fueling Europe's Crisis*, N.Y. TIMES, Feb. 13, 2010, at A1, *available at* http://www.nytimes.com/2010/02/14/business/global/14debt.html?em.

30. *See, e.g.,* Dennis Overbye, *They Tried to Outsmart Wall Street,* N.Y. TIMES, Mar. 10, 2009, at D1, *available at* http://www.nytimes.com/2009/03/10/science/10quant.html.

31. *See generally* Felix Salmon, *Recipe for Disaster: The Formula That Killed Wall Street*, WIRED MAG., (Feb. 23, 2009), http://www.wired.com/techbiz/it/magazine/17-03/wp_quant?currentPage=all ("[T]he CDS and CDO markets grew together, feeding on each other. At the end of 2001, there was $920 billion in credit default swaps outstanding. By the end of 2007, that number had skyrocketed to more than $62 trillion.").

risk on large pools of Derivatives based on historical data, concluding with a final "correlation number" that was voraciously consumed by Wall Street in the rampant pursuit of further securitization.[32] By 2007, the correlation number became ubiquitous in finance, but its fatal flaw surfaced when the underlying assets defaulted, failing to conform to the historical data the correlation represented.[33]

B. Derivatives and Financial Leverage

When contemplating the origins of the Crisis, many regulators point to the eradication of Glass-Steagall's wall between banking, insurance, and investment banking, which led to the subsequent creation of financial entities that were "too big to fail."[34] An interesting counter argument examines the Canadian banking system and its minimal (by comparison) losses, because, as opposed to the U.S., Canada is dominated by five "too big to fail" banks.[35] The main difference, it seems, is the regulatory inability of Canadian banks to employ extreme leverage or securitize (resell claims on) their loans outstanding.[36] Pre-Crisis leverage figures seem to support this argument: at the peak, the median large bank had debt of 37 times its equity.[37]

32. Overbye, *supra* note 30 ("[U]sing Li's copula approach meant that ratings agencies like Moody's—or anybody wanting to model the risk of a tranche—no longer needed to puzzle over the underlying securities. All they needed was that correlation number, and out would come a rating telling them how safe or risky the tranche was.")

33. *Id.*

34. *See* Paul Volcker, Op-Ed, *How to Reform Our Financial System,* N.Y. TIMES, Jan. 31, 2010, at WK11, *available at* http://www.nytimes.com/2010/01/31/opinion/31volcker.html?scp=3&sq=volcker&st=cse ("The phrase 'too big to fail' has entered into our everyday vocabulary. It carries the implication that really large, complex and highly interconnected financial institutions can count on public support at critical times.").

35. *See* Paul Krugman, Op-Ed, *Good and Boring,* N.Y. TIMES, Feb. 1, 2010, at A19, *available at* http://www.nytimes.com/2010/02/01/opinion/01krugman.html.

36. *Id.* ("[M]ore specifically, Canada has been much stricter about limiting banks' leverage . . . It has also limited the process of securitization . . . [A] process that was supposed to help banks reduce their risk by spreading it, but has turned out in practice to be a way for banks to make ever-bigger wagers with other people's money.").

37. *See* Mathew Valencia*, The Gods Strike Back,* THE ECONOMIST (Feb. 10, 2010),

In general, leverage allows financial institutions and investors to use diminutive amounts of capital to take much larger risks in the market.[38] Although leverage can make it more cost effective to hedge risk, it also allows for much cheaper speculation.[39] Randall Dodd, of the Derivatives Study Center of the Financial Policy Forum, provides a basic example:

> Instead of buying $1 million of Treasury bonds or $1 million of stock, an investor can buy futures contracts on $1 million of the bonds or stocks with only a few thousand dollars of capital committed as margin (the capital commitment is even smaller in the over-the-counter derivatives markets). The returns from holding the stocks or bonds will be the same as holding the futures on the stocks or bonds. This allows an investor to earn a much higher rate of return on their capital by taking on a much larger amount of risk.[40]

As the Crisis aptly demonstrated, an increased ability to take risk raises the probability that institutions will fail, which due to the interconnected nature of modern financial markets, exponentially increases the likelihood of systemic risk.[41] In an economic sense, this unregulated risk taking represents an externality that threatens the entire economy, particularly when viewed through the lens of taxpayer bailouts for failed financial firms. The apropos analogy is a casino where an investor/gambler can wager "house funds," keep obscene winnings, and then pass all losses back to the house. This "sleaze capitalism" privatizes profits and socializes losses, arguably representing one of the worst permutations of capitalism.[42]

In sum, Derivatives are supposed to reduce risk; however,

---

http://www.economist.com/specialreports/displayStory.cfm?story_id=15474137 ("[T]he debt of America's financial firms ballooned relative to the overall economy (see chart 1). At the peak of the madness, the median large bank had borrowings of 37 times its equity, meaning it could be wiped out by a loss of just 2-3% of its assets.").

38. *See* DODD, *supra* note 16, at 5–6.

39. *Id.*

40. *Id.*

41. *Id*. at 6.

42. *See* Nouriel Roubini, *The Stealth Public Bailout of Reckless "Countrywide": Privatizing Profits and Socializing Losses*, ROUBINI GLOBAL ECONOMICS (Nov. 27, 2007, 9:38 AM), http://www.roubini.com/roubini-monitor/228924/the_stealth_public_bailout_of_reckless_countrywide_privatizing_profits_and_socializing_losses.

these instruments can amplify risk with leverage and diffuse it around a complex chain of investors, imbuing systemic hazards. Although many Derivatives comprise a necessary part of the financial system, the Crisis has illuminated the folly of accepting an efficient Derivative market that needs little regulation.

III. THE CFMA

> I think we will look back in 10 years' time and say we should not have done this but we did because we forgot the lessons of the past, and that that which is true in the 1930's is true in 2010. . ..[W]e have now decided in the name of modernization to forget the lessons of the past, of safety and of soundness.[43]

At the legal heart of the Derivatives regulatory controversy is the CFMA. To understand the CFMA's context, one must delve into the political and economic climate at the millennium, where thirty years of deregulatory zeal culminated by seducing policy makers and market participants with the notion that modern financial instruments had eliminated the risks of the past.

A. Legislative History and Political/Economic Climate

Signed into law by President Clinton on December 21, 2000, the CFMA mutated the regulatory framework covering Derivatives by effecting changes in the Securities Act of 1933[44] ("*Securities Act*"), the Securities Exchange Act of 1934[45] ("*Exchange Act*"), Commodity Exchange Act[46] ("*CEA*"), and other federal regulations.[47]

From an economic standpoint, the millennial mood was one in which all the market mysteries had been solved and monetary policy would prevail indefinitely.[48] Efficient markets thrived,

43. *See* Stephen Labton, *Congress Passes Wide Ranging Bill Easing Bank Laws,* N.Y. TIMES, Nov. 5, 1999, at A1 (quoting Senator Byron L. Dorgan), *available at* http://www.nytimes.com/1999/11/05/business/congress-passes-wide-ranging-bill-easing-bank-laws.html?pagewanted=1

44. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 302(a), 114 Stat. 2763, 2763A-365 (2000).

45. § 303(a), 114 Stat. at 2763(a)-365.

46. §§ 108-111, 112(f)–253(b), 402–408, 114 Stat 2763, 2763(a)-365.

47. *See* Kloner, *infra* note 67, at 1.

48. *See* Krugman, *supra* note 6 (discussing how economists missed crisis warning signs, noting: "[O]livier Blanchard of M.I.T., now the chief economist at the International Monetary Fund, declared that 'the state of macro is good.'

economic actors were consistently rational, and asset prices (such as real estate) reflected all available information in the marketplace.[49] In 1999, a President's Working Group Report on OTC derivatives[50] ("*PWG*") recommended CEA exclusions for "sophisticated counterparties,"[51] based on efficient market assumptions and the ability of sophisticated investors to manage risk.

The PWG included the Chairman of the SEC, the Chairman of the CFTC, the Treasury Secretary, and the Chairman of the Federal Reserve.[52] Interesting political parallels exist; many of these economic policy makers had heavy Wall Street ties and added to the deregulatory zeal.[53] Federal Reserve Board Chairman Alan Greenspan's laissez-faire approach to financial markets endorsed the proliferation of Derivatives and greater concentration within the financial sector.[54] Robert Rubin, then Treasury Secretary, and his deputy Lawrence Summers both had significant Wall Street ties and played a role in the economic policy rationales behind the deregulation of Derivatives.[55] The triumvirate of Greenspan, Rubin and Summers also quashed any attempts to extend capital requirements to Derivatives during the 1990's, contravening the views of CFTC Chairperson Brooksley Born.[56]

The battles of yesteryear, he said, were over, and there had been a 'broad convergence of vision.'").

49. *See id.*

50. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (1999), www.treas.gov/press/releases/reports/**otc**act.pdf.

51. *Id*. at 2–3.

52. *Id*. at 4.

53. *See generally* Peter S. Goodman, *Taking a Hard New Look at the Greenspan Legacy,* N.Y. TIMES, Oct. 8, 2009, at A1 (reporting on Robert Rubin and Lawrence Summer's Wall Street ties)., *available at* http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html.

54. *See id.* ("[F]or more than a decade, the former Federal Reserve Chairman Alan Greenspan has fiercely objected whenever derivatives have come under scrutiny in Congress or on Wall Street."); *see also* Paul Krugman, *Making Financial Reform Fool-Resistant*, N.Y. TIMES, Apr. 5, 2009, at A19 (quoting Alan Greenspan in 2005, noting that "[i]ncreasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system."), *available at* http://www.nytimes.com/2010/04/05/opinion/05krugman.html?hp.

55. *See* Goodman*, supra* note 53.

56. *See id.* (reporting that CFTC chairperson Brooksley Born's effort to bring regulation to Derivative markets was rebuked by Greenspan, Rubin, and

Adding to a sunny economic climate ripe for deregulation, large Wall Street banks spent over $5 billion from 1998–2000 to lobby for an overhaul of Glass-Steagall in the Gramm-Leach-Bliley Act and enact the more obscure CFMA.[57] During the three years of congressional negotiation leading up to the CMFA's passage, and until the Crisis, much of the legislative urgency revolved around the unsubstantiated threat of losing financial business to overseas markets with less regulation.[58] In a bizarre episode of amnesia, the financial industry continues to advance that fallacious argument to avoid new regulations, even after the Crisis.[59] The argument carries little weight, however, considering the global regulatory response and the U.K.'s current imposition of 50% bonus taxes on banker bonuses.[60]

Against the backdrop of this perfect politico-economic storm, the CFMA came into existence as the legislative brainchild of Wall Street, Senator Lindsay Gramm, and his wife, an Enron board member and former chairperson of the CFTC.[61] A year earlier, in 1999, Senator Gramm sponsored the Gramm-Leach-Bliley Act that

---

Summers).

57. *See* Brian Montopoli, *Report: Wall Street Spent 5 Billion for Political Influence*, CBS NEWS (Mar. 4, 2009), http://www.cbsnews.com/blogs/2009/03/04/politics/politicalhotsheet/entry4842645.shtml.

58. *See* Goodman, *supra* note 53 (reporting that when concerns about the OTC Derivative market were raised by Brooksley Born, Alan Greenspan "warned that too many rules would damage Wall Street, prompting traders to take their business overseas."); *see also* Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn from London*, WALL ST. J., Nov.1, 2006, at A18, available at http://online.wsj.com/article/SB116234404428809623-search.html; *see generally* Eric Dash, *Few Fled Companies Constrained by Pay Limits*, N.Y. TIMES, Mar. 23, 2010, at A18, *available at* http://www.nytimes.com/2010/03/23/business/23pay.html?ref=business ("[O]f the 104 senior executives whose pay was set by the federal pay regulator in the last two years, 88 executives, or nearly 85 percent, are still with the companies even though their pay was drastically cut back . . . ").

59. *See generally* David D. Kirkpatrick, *In a Message to Democrats, Wall St. Sends Cash to G.O.P.*, N.Y. TIMES, Feb. 8, 2010, at A1 (reporting on industry lobbying efforts against regulation and bank tax), *available at* http://www.nytimes.com/2010/02/08/us/politics/08lobby.html.

60. *See* Patrick Jenkins, Brooke Masters & Francesco Guerrera, *What Banker Wants to be in the UK?*, THE FINANCIAL TIMES (Dec. 9, 2009), http://www.ft.com/cms/s/0/6284fdba-e4c3-11de-96a2-00144feab49a.html.

61. *See* Eric Lipton, *Gramm and the Enron Loophole*, N.Y. TIMES (Nov. 14, 2008), http://www.nytimes.com/2008/11/17/business/17grammside.html?pagewanted=1.

repealed Glass-Steagall's hermetic seal between banking, investment banking, and insurance. That monumental gift to financial firms concluded decades of lobbying and billions spent to realize the repeal.[62] Approval of the CFMA occurred in December 2000, just one month before Bill Clinton's term ended, and emails between Enron executives, lobbyists and corporate counsel show a coordinated effort to control the process.[63] The emails also reveal the extreme influence Enron had with Senator Gramm, and the length of Wendy Gramm's involvement in CFTC affairs.[64]

B. Key Provisions

The CFMA made two notable (and arguably disastrous) changes to previous regulation of Derivatives markets by: (1) exempting certain OTC Derivatives from the jurisdiction of the CFTC,[65] and (2) allowing futures contract trading based on single stocks or indices.[66] The CFMA contains four titles that limit the scope of the CEA and amend the CEA, the Securities Act, the Exchange Act and the Shad-Johnson Accord.[67]

1.Treasury Amendment

Before the CFMA's enactment, foreign currency transactions and many CDO's were excluded from the CEA pursuant to the "Treasury Amendment."[68] This provision created uncertainty concerning financial instrument coverage,[69] particularly as new and exotic variations began to explode onto the market during the

62. *Id.*; *see also* Montopoli*, supra* note 57.

63. Lipton, *supra* note 61.

64. *Id.*

65. 15 U.S.C. § 77(b)(1) (2000).

66. § 77(b)(1); *see also* Dean Kloner, *The Commodity Futures Modernization Act of 2000*, 29 SEC. REG. L. J. 286, 286 (2001), *available at* http://www.stroock.com/SiteFiles/Pub134.pdf.

67. *See generally* Consolidated Appropriations Act, 2001 Pub. L. No. 106-554, 114 Stat. 2763 (2000).

68. 7 U.S.C. § 2(a) (2010).

69. *See* John Riley & Michael B. Garcia, *The Commodity Futures Modernization Act of 2000*, SIMPSON THATCHER & BARTLETT, LLP, at 1 (Feb. 2, 2001), http://www.stblaw.com/content/publications/pub370.pdf ("Section 2(a)(1)(A)(ii) of the CEA, excluded from the CEA foreign currency transactions, as well as security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, and mortgages or mortgage purchase commitments.").

1990's. Accordingly, the CFMA allows a clear exclusion from CFTC jurisdiction for any of the enumerated transactions between "eligible contract participants,[70]" ("*ECP*") a term defined broadly to allow any individual or entity meeting certain financial criteria to enter into a transaction for risk management.[71]

2. Commodities

The CFMA continues a laissez-faire approach by extending many exemptions and exclusions to OTC Derivatives, Swaps, and commodities. A notable broad exclusion removes CEA jurisdiction over transactions involving an "excluded commodity,"[72] as well as any contracts in "exempt commodities"[73] such as energy and metals, allowing those commodities to be traded in the OTC market with little regulation.[74] That notorious provision garnered the "Enron Loophole" moniker after the disastrous collapse of Enron.[75]

Another subsection relates to CDS's and other negotiated "swap" agreements, excluding these credit Derivatives from the definition of a "security" under the Securities Act and the Exchange Act when entered into by ECP's.[76] Aside from that exclusion, the vast majority of swaps would fall under the SEC's jurisdiction per the "investment contract" definition of a security,[77] because in a swap agreement profit is derived from the efforts of others.[78]

---

70. 7 U.S.C. § 2(d) (2010).

71. Riley & Garcia, *supra* note 70.

72. *Id*. ("[T]he CFMA defines 'excluded commodity' to include: an interest rate, exchange rate, currency, security, security index, credit risk, debt or equity instrument, index or measure of inflation, or a host of other measures not within the parties' control.").

73. 7 U.S.C. § 2(h).

74. Kloner, *supra* note 67, at 290.

75. *See* Lipton, *supra* note 61.

76. Commodiy Futures Modernization Act § 206(C); Riley & Garcia, *supra* note 70, at 2.

77. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2010).

78. *See* Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. RICH. L. REV. 647, 664 (2010); SEC v. W.J. Howey, 328 U.S. 293, 301 (1946) (noting "[T]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative, or whether

3. Hybrid Instruments

The CFMA also extends regulatory exclusions to certain "Hybrid Instruments,"[79] defined as "securit[ies] having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities."[80] The exclusion applies if the hybrid instrument is "predominantly a security."[81] Under the statute, a hybrid instrument is predominantly a security if: (a) the issuer receives payment in full of the purchase price contemporaneously with delivery of the instrument; (b) the purchaser is not required to make any payment to the issuer over the purchase price (e.g., margin or settlement payments); (c) the issuer of the hybrid is not subject to mark-to-market margining requirements; and (d) the hybrid is not marketed as a futures contract or option thereon.[82] This exclusion removed hybrid instrument transactions from the more stringent requirements imposed by the CFTC.[83]

4. Banking Products

Certain "identified banking products" are also excluded from the CEA if a banking agency certifies the product has been offered in the U.S. prior to December 5, 2000 and the product is not regulated as a futures contract.[84] Further, a product offered after December 5, 2000 is also excluded if the payment is not indexed to the value of a commodity.[85] In hindsight, those exclusions facilitated the rampant rise in bank securitization of mortgage loans and other assets. The CFMA also repeals the Shad-Johnson Accord's prohibition of trading futures on non-exempt securities or indices of securities, which significantly reduces the restrictions on securities-based derivatives.[86]

---

there is a sale of property with or without intrinsic value.").

79. Commodity Futures Modernization Act § 402(c).

80. § 402(c); Kloner, *supra* note 67, at 291.

81. § 105(a)(2)(a)–(d).

82. § 105(a)(2)(a)–(d); Kloner, *supra* note 67, at 291–292.

83. Riley & Garcia, *supra* note 70, at 3 ("The new predominance test applied to hybrid instruments eliminates the need for hybrids to meet mechanical quantitative requirements formerly imposed by the CFTC under its statutory interpretation and hybrid instrument rules.").

84. 7 U.S.C. § 27(a) (2006).

85. 7 U.S.C. § 27(a).

86. *Compare* Futures Trading Act of 1982, Pub. L. No. 97-444, tit. 1, 96

5. Derivative Transactions Execution Facilities

Finally, the CFMA creates a tiered regulatory approach to different markets, particularly the contracts market and futures exchanges.[87] The contracts market garners the highest amount of regulation, while less regulation applies to "Registered Derivatives Transaction Execution Facilities" ("*RDTEF*") and exempt "Boards of Trade." For example, a certain CFMA "innovation" allows ECP's operating a RDTEF to trade futures and options on any commodity and circumvent the more stringent restrictions that would be applicable to these instruments in the contracts market.[88] Even less regulation applies to exempt Boards of Trade, although participants are restricted to ECP's, and products are restricted to those that have an "inexhaustible deliverable supply" and are not likely to be subject to manipulation.[89]

C. Regulatory Disconnect Between the CFTC and SEC

Prior to the CFMA's enactment, agency regulation of Derivatives was characterized by a void of legal uncertainty between the SEC and the CFTC.[90] That regulatory gap developed because some Derivatives fell into the securities category, while others fell into the commodity futures category.[91] Some jurisdictional disputes were resolved in the 1982 Shad-Johnson Accord, allowing the SEC to retain jurisdiction over securities and options, while the CFTC would continue to regulate futures contracts and CDS's.[92] Until the 1980's, regulations only allowed Derivative trading in regulated commodities markets; however,

---

Stat. 2294 (1983) (codifying Shad-Johnson Accord), *with* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000).

87. *See generally* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365.

88. See 7 U.S.C. § 7a(a) *See* Kloner, *supra* note 67, at 294–95.

89. *See* 7 U.S.C. § 7a-3(b)(1); *see also* Kloner, *supra* note 67, at 295.

90. *See*, *e.g.*, U.S. COMMODITIES FUTURES TRADING COMM'N AND SEC. & EXCH. COMM'N, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION 2 (2009), *available at* http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

91. See *id. at* 2–3.

92. *See* Securities Acts Amendments of 1982, Pub. L. No. 97-303, 96 Stat. 1409 (1982) (amending § 2 of the Securities Act of 1933 and § 3 of the Securities Exchange Act of 1934); *see also* The Futures Trading Practices Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983).

after the Shad-Johnson Accord, certain CFTC exemptions allowed the OTC Derivative market to expand in the 1990's.[93] This laissez-faire attitude, espoused by policy makers, culminated with the CFMA's exemption of most OTC Derivatives under an efficient market rationale.[94] Jurisdictional issues between the SEC and CFTC continue, although a recent joint report of the two agencies seeks uniformity in future regulation of many Derivative varieties.[95]

IV. THE NEED FOR DERIVATIVE TRANSPARENCY

A. *Current State of Derivative Markets*

The Crisis continues to initiate considerable debate on the transparency and disclosure of Derivatives in financial markets. The CFMA relaxed regulatory standards and permitted increasingly sophisticated Derivatives to remain undetected by regulators and investors, rendering market participants unable to grasp the underlying structure of the assets or the risks involved. For instance, according to third quarter 2009 figures compiled by the Office of the Comptroller of the Currency, just five U.S. banks hold 97% of all U.S. bank Derivatives positions in terms of notional values, and 88% of the total net credit risk exposure in event of default.[96] The total notional values of the derivatives held by these commercial banks topped $204 trillion, dispersed among JPMorgan Chase ($78 trillion); Goldman Sachs ($42 trillion); Bank of America ($40 trillion); Citibank ($32 trillion) and Wells

---

93. *See* Thomas Lee Hazen, *Filling a Regulatory Gap: It is Time to Regulate Over-The-Counter-Derivatives*, 13 N.C. BANKING INST., 123, 128 (2009), *available at* http://studentorgs.law.unc.edu/documents/ncbank/volume13/hazen.pdf.

94. *See id.*

95. *See generally* U.S. COMMODITY FUTURES TRADING COMM'N & U.S. SEC. & EXCH. COMM'N, *supra* note 91.

96. OFFICE OF THE COMPTROLLER OF THE CURRENCY, ADMINISTRATOR OF NATIONAL BANKS, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES THIRD QUARTER 2009 1 (2009), *available at* http://www.occ.treas.gov/ftp/release/2009-161a.pdf ("[N]onetheless, derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Five large commercial banks represent 97% of the total banking industry notional amounts and 88% of industry net current credit exposure.").

Fargo ($4.5 trillion).[97] The most recent statistics on global OTC Derivatives in June 2009 from the Bank for International Settlements place the market near $604 trillion.[98]

Many question the social value of Derivatives and commodity speculation in general, arguing, for example, that incentives are skewed when traders can reap $100 million bonuses by storing oil offshore in supertankers, betting the price of oil will exceed the storage costs during a fixed time period.[99] Recent revelations concerning Wall Street's culpability in Greece's sovereign debt default have also bolstered arguments that Derivatives (as currently regulated) produce calamitous rather than copacetic financial results.[100] The irony of the Greek crisis could not be more pronounced: Goldman Sachs and other Wall Street banks quietly assisted Greece in masking billions in debt with interest rate Derivatives in 2001, and in 2009 immediately prior to Greece's default.[101] Simultaneously, a Goldman Sachs subsidiary exchange in London facilitated heavy trading in CDS's on Greek debt, signaling a rise in the cost of these insurance contracts, which made it harder for Greece to sell bonds and in turn affected their ability to borrow.[102] In essence, Goldman Sachs profited from the

97. *Id.* at table 1.

98. *Amounts outstanding of over-the-counter (OTC) derivatives*, BANK FOR INTERNATIONAL SETTLEMENTS (June 2010), http://www.bis.org/statistics/otcder/dt1920a.pdf.

99. *See, e.g.*, David Segal, *$100 Million Payday Poses Problem for Pay Czar*, N.Y. TIMES, Aug 2, 2009, at A1, *available at* http://www.nytimes.com/2009/08/02/business/02bonus.html?_r=1; *see also* Edmund L. Andrews, *U.S. Considers Curbs on Speculative Trading of Oil*, N.Y. TIMES, July 8, 2009, at A1, *available at* http://www.nytimes.com/2009/07/08/business/08cftc.html?_r=1.

100. *See generally* Editorial, *A.I.G., Greece, and Who's Next?,* N.Y. TIMES, Mar. 5, 2010, at A26, *available at* http://www.nytimes.com/2010/03/05/opinion/05fri1.html?hp.

101. *See* Story, Thomas Jr. & Schwartz, *supra* note 21, at A1 ("[A]s in the American subprime crisis and the implosion of the American International Group, financial derivatives played a role in the run-up of Greek debt. Instruments developed by Goldman Sachs, JPMorgan Chase and a wide range of other banks enabled politicians to mask additional borrowing in Greece, Italy and possibly elsewhere.").

102. *See* Nelson D. Schwartz & Eric Dash, *Banks Bet Greece Defaults on Debt They Helped Hide*, N.Y. TIMES, Feb. 5, 2010, at A1, *available at* http://www.nytimes.com/2010/02/25/business/global/25swaps.html?hp ("[A] result, some traders say, is a vicious circle. As banks and others rush into these swaps, the cost of insuring Greece's debt rises. Alarmed by that bearish signal, bond investors then shun Greek bonds, making it harder for the country to

original Derivative package, and then profited from CDS contracts on a debt catastrophe they engineered. Indeed, the same self-fulfilling gambles may undermine other indebted Eurozone nations such as Spain, Portugal and Italy as CDS traders and hedge funds turn their attention elsewhere.[103]

On the U.S. home front, those same swap arrangements are poised to cripple municipalities and other tax-exempt debt issuers who bought into interest rate swaps as a way to reduce financing costs.[104] Unfortunately, rapidly evolving financial and economic circumstances turned those seemingly benign financing instruments into oppressive and inescapable debt burdens.[105]

B. Proposed House and Senate Legislation

In response to the Crisis, the Treasury Department proposed the Over-the-Counter Derivatives Markets Act[106] ("*OCDMA*") on August 11, 2009, which concluded the proposed regulatory reforms issued in a June 2009 Treasury Department white paper.[107]

---

borrow. That, in turn, adds to the anxiety — and the whole thing starts over again.").

103. *See* Nelson D. Schwartz & Graham Bowley, *Traders Seek Out the Next Greece in an Ailing Europe*, N.Y. TIMES Mar. 4, 2010, at B1, *available at* http://www.nytimes.com/2010/03/04/business/global/04bets.html?ref=business ("[I]ndeed, some banks and hedge funds have already begun to turn their attention to other indebted nations, particularly Portugal, Spain, Italy and, to a lesser degree, Ireland.").

104. *See* Gretchen Morgenson, *The Swaps That Swallowed Your Town*, N.Y. TIMES, Mar. 7, 2010, at BU1, *available at* http://www.nytimes.com/2010/03/07/business/07gret.html?ref=business ("Now, however, the promised benefits of these swaps have mutated into enormous, and sometimes smothering, expenses."); *see also* Mary Williams Walsh, *State Debt Woes Grow Too Big to Camouflage,* N.Y. TIMES, Mar. 30, 2010, at A1, *available at* http://www.nytimes.com/2010/03/30/business/economy/30states.html?hp ("California, New York and other states are showing many of the same signs of debt overload that recently took Greece to the brink — budgets that will not balance, accounting that masks debt, the use of derivatives to plug holes.").

105. *See* Walsh, *supra* note 105, at A1.

106. Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong. (2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3795ih.txt.pdf.

107. REGULATORY REFORM, DEPARTMENT OF TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf; *see also Title VII — OTC Derivatives Markets Act of 2009 Derivatives Update*, SIDLEY AUSTIN LLP, (Aug. 27, 2009),

After months of political posturing and debate, many of the OCDMA provisions passed the House of Representatives on December 11, 2009 in the "Derivatives Markets Transparency and Accountability Act"[108] of the Wall Street Reform and Consumer Protection Act of 2009[109] ("*House Bill*").[110] All regulatory hopes now hinge on a reconciliation of the House Bill and "The Over-the-Counter Derivatives Markets Act"[111] of the "Restoring American Financial Stability Act of 2009"[112] ("*Senate Bill*"), currently in a discussion draft iteration in the Senate.[113] In some aspects, both bills affect some positive changes in the regulation of Derivatives and repeal portions of the CFMA. However, many loopholes exist and the current odds of reconciling the two bills for bicameral passage seems unlikely.[114] The following is a brief comparison of the major Derivative sections of the House Bill and the current working draft of the Senate Bill.

1. Swaps

The House Bill alters many of the OTC Derivative exemptions under the CFMA and maintains the same jurisdictional distinctions, allowing the SEC to regulate "security based" swaps (equity swaps and CDS's) and the CFTC to regulate all other OTC swaps.[115] The Senate Bill mirrors these jurisdictional definitions; however, the swap definition exempts foreign exchange swaps in

http://www.sidley.com/sidleyupdates/Detail.aspx?news=4143.

108. Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009).

109. Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).

110. Mark N. Rae, *The Major Derivative Provisions of the Financial Markets Reform Bill Passed by the House*, STROOK & STROOK & LAVAN LLP (Jan. 11, 2010), http://www.stroock.com/SiteFiles/Pub877.

111. Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795 111th Cong. (2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3795ih.txt.pdf.

112. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010).

113. *See* Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong. (2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3795ih.txt.pdf.

114. *Compare* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2009), *with* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010).

115. Rae *supra* note 111, at 1 (discussing H.R. 4173, 111th Cong.).

both.[116] Both bills distinguish between "Dealers" ("*Dealers*") and "Major Participants"[117] ("*Major Participants*"). The House Bill defines a Dealer as a person who regularly engages in the purchase and sale of either type of instrument.[118] Major Participants are dealers who: (1) "maintain a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing, or otherwise mitigating its commercial risk;"[119] or (2) "whose outstanding swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."[120] Controversially, the House Bill also creates (although not expressly) an exemption for Dealers who are not subject to regulation as a Dealer or Major Participant, but maintain substantial positions in swaps or security-based swaps for the purpose of "risk management" and could not seriously effect financial markets ("*Commercial Participants*").[121]

2. Capital Requirements

Dealers and Major Participants would also be subject to minimum capital and margin requirements under both bills, as well as registration with either the SEC or CFTC as applicable.[122] This represents a marked improvement on the CFMA's previous OTC Derivative free for all. Under the House Bill, however, capital and margin requirements do not extend to Commercial Participants.[123]

3. Clearing and Exchange

One of the major Crisis issues, particularly in the CDS market, related to CDS counterparty failure, as illustrated in the

116. H.R. 4173, 111th Cong. § 3101; S. 3217, 111th Cong. § 711(a)(34)(B); *see* Morrison Foerster LLP, *Commodities and Derivatives Reform (As of January 1, 2010)*, JD Supra (Jan. 1, 2010), http://www.jdsupra.com (search "commodities and derivatives reform").

117. H.R. 4173, 111th Cong. § 3101; S. 3217, 111th Cong. § 711.

118. H.R. 4173, 111th Cong. § 3101..

119. Rae *supra* note 111, at 1 (discussing H.R. 4173, 111th Cong.).

120. *Id.*

121. Rae, *supra* note 111,.at 3.

122. Morrison Foerster, *supra* note 117, at 2 (discussing H.R. 4173, 111th Cong. § 3107, and S. 3217, 111th Cong. §§ 713, 717).

123. Rae, *supra* note 111, at 4 (discussing H.R. 4173, 111th Cong.).

case of Lehman Brothers.[124] One way to reduce risk from counterparty failure is by centrally "clearing" CDS's through a centralized clearing counterparty ("*CCP*").[125] In a CCP swap transaction, both counterparties assign their trades to the CCP who ensures financial solvency and on time payments, thus reducing systemic risk and increasing market transparency.[126] Because of this demonstrably effective risk reduction, both bills give the CFTC and SEC jurisdiction to require clearing through a registered clearing organization or agency.[127] For example, the House Bill requires clearing if: (1) "a registered clearing organization or agency will accept the swap or security-based swap for clearing,"[128] and (2) "the CFTC or the SEC, as applicable, has determined that such swap or security-based swap is required to be cleared."[129] The CFTC and SEC may consider various factors in determining whether the swap is one that necessitates clearing.[130]

Again, an exception to the clearing requirement exists if one of the counterparties is a Commercial Participant who "notifies the CFTC or SEC, as applicable, how it generally meets its financial obligations associated with entering into non-cleared transactions."[131] The Senate bill does not currently contain that Commercial Participant exception, and under both bills, non-exempt, cleared, swaps must trade on an exchange or "swap execution facility."[132]

---

124. *See* Kiff, Elliott, Kazarian, Scarlata & Spackman, *supra* note 9, at 15 ("Counterparty risks arise in the CDS market because each contract is subject to the potential risk that the protection seller will fail and be unable to uphold the original contract. The failure of Lehman Brothers on September 15, 2008 highlighted the potential for systemic disruption following the simultaneous failure of a major CDS protection seller and an actively traded reference entity, due to the large overhang of offsetting bilateral contracts.").

125. *Id*. at 17.

126. *Id*. ("A CCP reduces systemic risk by applying multilateral netting of trades, which not only reduces counterparty risk, but minimizes cash flows between counterparties (see Box 2). Moreover, the CCP increases the transparency of the CDS market, as it maintains records of CDS transactions, including the volumes and identity of each party.").

127. *See* Morrison Foerster, *supra* note 117, at 2 (discussing H.R. 4173, 111th Cong., and S. 3217, 111th Cong.).

128. Rae, *supra* note 111, at 4 (discussing H.R. 4173, 111th Cong.)..

129. *Id.*

130. *Id.*

131. *Id.* at 5.

132. *Id.* at 6 (discussing S. 3217, 111th Cong. § 753, and H.R. 4173, 111th Cong. § 3109).

4. Position Limits

Finally, on the leverage front, both bills authorize the CFTC and SEC to establish "position limits" on both swaps and security based swaps.[133] That would allow either agency to impose limits on the size of positions that a market participant may hold in a futures contract, an option on a futures contract, or an economic equivalent.[134] By itself, that provision would represent an effective tool against excessive leverage in the commodities markets; however, the House Bill contains a narrow (yet ambiguous) exception for "bona fide hedge positions," which limits its otherwise broad scope.[135]

C. Closing the Loopholes

Even a cursory glance at the House Bill reveals numerous loopholes that could undermine effective regulation and sow the seeds of the next financial meltdown. Both the SEC and the CFTC have articulated the same conclusion, while financial and business lobbyists applaud the bill in its current form.[136] To realize effective future regulation and circumvent the next disaster, an alteration of several glaring loopholes is necessary before a final bicameral bill passes.

First, unless otherwise determined by the CFTC and the Treasury, both bills exclude foreign exchange Derivatives (swaps and forwards) from the definition of "swap,"[137] effectively continuing a policy of lax regulation in this large market.[138] On August 17, 2009, in a letter commenting on the OCDMA, CFTC Chairman Gary Gensler advised Congressional leaders that foreign

133. *Id.* at 7 (discussing H.R. 4173, 111th Cong. § 3113, and S. 3217, 111th Cong. § 720).

134. *Id.*

135. H.R. 4173, 111th Cong. § 3113; Rae, *supra* note 111 at 7 (noting that the exception is limited "to a transaction (i) that, among other things, represents a substitute for a transaction made or to be made at a later time in a physical marketing channel . . . or (ii) that reduces the risks attendant to a position resulting from a swap executed opposite a counterparty for which the transaction would meet the standard described in clause (i).").

136. *See generally* Teena Seeley & Dawn Kopecki, *Derivatives Bill's Loophole May Exempt Most Firms, Gensler Says*, BLOOMBERG (Oct. 8, 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=a7fAFtZGaGAk.

137. H.R. 4173, 111th Cong. § 3101; S. 3217, 111th Cong. § 711..

138. *See* Morrison Foerster, *supra* note 117, at 1.

exchange swaps should be included in the definition of "swap."[139] He reasoned that the exclusion would give Dealers and Market Participants incentive to restructure transactions as foreign exchange transactions to fall outside of regulation.[140] Instead, Gensler advised congressional leaders to include foreign exchange swaps within the definition, while only excluding foreign exchange forward transactions with retail customers.[141] That approach would narrow the exclusion and discourage or eliminate the hazard of firms restructuring into foreign exchange transactions. Based on those recommendations, in November of 2009, Representative Barney Frank vowed to remove the foreign exchange exemption.[142] In spite of that declaration, the exemption remains in the final House Bill.[143] Considering the machinations of financial firms leading up to the Crisis, that argument seems quite plausible. In fact, it doesn't take a stretch of imagination to believe investment banks may already have such products in production.

Second, and most pressing, is the "end user" exemption ("*Exemption*") in the House Bill that exempts Commercial Participants from Dealer and Market Participant obligations such as reporting, capital, and margin requirements.[144] Under the OCDMA, the Treasury proposed exchange trading or clearinghouse processing for "standardized" Derivatives.[145] Unfortunately, significant corporate lobbying efforts have emasculated the stronger OCDMA provision based on arguments that such regulations would make Derivatives too cost

139. *See* Sullivan & Cromwell LLP, *CFTC Chairman Seeks Additional Authority for CFTC,* SULLIVAN & CROMWELL LLP, at 1–2, (Aug. 31, 2009), http://www.sullivanandcromwell.com/publications/detail.aspx?pub=666. *www.sullcrom.com/.../SC_Publication_CFTC_Chairman_Seeks_Additional_Authority_for_CFTC.pdfwww.sullcrom.com/.../SC_Publication_CFTC_Chairman_Seeks_Additional_Authority_for_CFTC.pdf*

140. *Id.*

141. *Id* at 2.

142. *See* Peter Madigan, *House OTC Derivatives Vote Leaves FX Exemption Question Unanswered*, RISK MAGAZINE, Dec. 16, 2009, http://www.risk.net/risk-magazine/news/1566279/house-otc-derivatives-vote-leaves-fx-exemption-question-unanswered .

143. *Id.*; *see also* Morrison Foerster, *supra* note 117.

144. *See* Rae, *supra* note 111, at 3 (discussing H.R. 4173, 111th Cong.).

145. *See* Seeley & Kopecki, *supra* note 137 ("[T]he administration's plan would force all standardized derivatives transactions to be executed on an exchange or processed through a regulated clearinghouse, which impose collateral and margin requirements on trades.").

prohibitive.[146] The same argument of maintaining competitiveness in the world markets emerges among politicians and lobbying groups in defense of the Exemption.[147]

As currently drafted, the Exemption would exempt insurance companies, many corporations, and possibly hedge, mutual and private equity funds.[148] Gary Gensler has also warned of the Exemption's dangers in recent speeches, observing in a January, 2010 speech that:

When a corporation or another end-user wants to hedge a risk, they go to their bank and get a price quote. When they enter into transactions, those transactions largely stay on the books with their banks. The price is not discovered on transparent trading venues, such as exchanges, and the risk is not transferred from the dealer's books to a central clearinghouse. This leaves significant risk in the system.[149]

To avoid that potential regulatory evasion, Mr. Gensler argues that end-users "should establish a client relationship with a clearing member who would then clear the transaction for the end-user, through a client account."[150] That argument is also persuasive: it would ensure swap transaction transparency through clearing without imposing heavy cost burdens on end-users. Henry

146. *See* Graham Bowley, *Goldman Deal Maker Now Advocates Regulation*, N.Y. TIMES, Mar. 11, 2010, at B1, *available at* http://www.nytimes.com/2010/03/11/business/11cftc.html?pagewanted=1&ref=business (reporting on CFTC Chairman Gary Gensler, noting "[o]rganizations including the United States Chambers of Commerce have formed the Coalition of Derivatives End-Users, representing about 170 companies including Coca-Cola, Caterpillar and General Electric. The group argues that the changes could make derivatives too expensive for them to use — or tie up capital they should be putting to work in their businesses.").

147. *See* Seeley & Kopecki, *supra* note 137 (quoting House Financial Services Committee Member and New York Democrat Mike McMahon who stated: "[w]ith derivatives, a lot of people think it's about speculation, but it's about good American companies hedging their risks so they can be vibrant and competitive in the world market[.]").

148. *See* Greider, *supra* note 8 at 2 (reporting on House Bill exemptions, noting "[t]he exemption for "end users" contained in the committee's final legislation is a major loophole--so vaguely defined it exempts insurance and mutual funds and might even be construed to protect hedge funds and private-equity capital from the disclosure of trading derivatives on public exchanges.").

149. *See* Kari S. Larsen, *What Is the End Game for the "End User" Exemption*?, SECURITIES TECHNOLOGY MONITOR, (Feb. 5, 2010), http://www.securitiesindustry.com/issues/22_2/-24628-1.html?zkPrintable=true (quoting Gary Gensler).

150. Sullivan & Cromwell LLP, *supra* note 140, at 2.

T.C. Hu, the director of the SEC's new division of risk, strategy, and financial innovation also affirms Mr. Gensler's repudiation of the Exemption and its "ambiguous" definition of risk management.[151]

In sum, current legislation, although a "step in the right direction,"[152] requires redrafting to close loopholes, particularly those concerning foreign exchange transactions and the Exemption. CFTC and SEC regulators, who understand the ease with which Wall Street can retool transactions to evade regulation, affirm that view.

D. The Future of Derivatives

The main hope for responsible Derivative regulation rests on a remediation of these exemptions in a reconciliation of the two bills. Current political indicators, however, temper this hope with pessimistic realism. House Republicans, who unanimously opposed the House Bill, have advanced a "market discipline" counter proposal, which would theoretically adhere to a "no bank bailout" policy.[153] This proposal seems to represent political pandering rather than plausible policy, and history reveals that even the father of free-market economics, Adam Smith, regarded banking regulations as indispensible.[154] As a corollary, a recent paper by Andrew Heldane, head of financial stability at the Bank of England, uses historical data to argue that the moral hazard of implicit government support for the banking industry creates an incentive for firms to take larger risks.[155] Mr. Heldane

151. Seeley & Kopecki, *supra* note 137 ("[W]hile Frank's proposal is a 'step in the right direction,' its 'ambiguous' definition of risk management may leave a large number of corporations unregulated, Henry T.C. Hu, director of the SEC's new division of risk, strategy and financial innovation, told the committee.").

152. *Id.*

153. Paul Krugman, *Financial Reform Endgame*, N.Y. TIMES, Mar. 1, 2010, at A27, *available at* http://www.nytimes.com/2010/03/01/opinion/01krugman.html?hp ("[H]ouse Republicans, offering their alternative proposal, claimed that they would end banking excesses by introducing "market discipline" — basically, by promising not to rescue banks in the future.").

154. *Id.* ("[E]ven Adam Smith knew that: he may have been the father of free-market economics, but he argued that bank regulation was as necessary as fire codes on urban buildings, and called for a ban on high-risk, high-interest lending, the 18th-century version of subprime.").

155. *See* ANDREW HELDANE & PIERGIORGIO ALESSANDRI, FEDERAL

characterizes the relationship between government and banking systems as a cyclical "doom loop" where governments always have (and always will) come to the rescue when financial "innovation" fails.[156]

Recent news reports show little progress in the Senate based on disagreements about the Senate Bill's inclusion of a new consumer protection agency, a feature opposed by Republicans and bank lobbyists.[157] Although statements by ranking members of the Senate Banking Committee portend the possibility of a bill passing this year,[158] there are no assurances on the elimination of any exemptions. Based on the current iterations, some argue that the U.S. may be better off if Democrats refuse to accept such a watered down version.[159] Moreover, the recent trend of Wall Street contributions shifting to Republicans because of their opposition to many financial reforms does not bode well for bipartisan reform.[160]

RESERVE BANK OF CHICAGO TWELFTH ANNUAL INTERNATIONAL BANKING CONFERENCE ON "THE INTERNATIONAL FINANCIAL CRISIS: HAVE THE RULES OF FINANCE CHANGED?", BANKING ON THE STATE (2009), *available at* http://www.bis.org/review/r091111e.pdf.

156. *Id*. ("[S]ocialised losses are doubly bad for society . . . [T]his is a repeated game. State support stokes future risk-taking incentives, as owners of banks adapt their strategies to maximise expected profits. So it was in the run-up to the present crisis.").

157. *See, e.g.,* Kevin Drawbaugh, *Financial Reform Bill Faces Tough Slog in US Senate*, REUTERS (Feb. 27, 2010), http://www.reuters.com/article/idUSN2718350620100228 ("[U]rgent talks in the U.S. Senate on financial regulatory reform extended into Saturday, but little support emerged for the latest attempt by Democrats to compromise on a key issue -- financial consumer protection.").

158. *See* Sewell Chan, *Traction for Banking Regulation,* N.Y. TIMES, Feb. 26, 2010, at B1 (reporting that Christopher Dodd and Richard C. Shelby agree on about 90% "of everything"), *available at* http://www.nytimes.com/2010/02/26/business/26regulate.html?ref=business

159. Krugman, *supra* note 154.

160. *See* Kirkpatrick, *supra* note 59 (reporting on J.P. Morgan Chase's contribution shift, noting that "[r]epublicans are rushing to capitalize on what they call Wall Street's 'buyer's remorse' with the Democrats. And industry executives and lobbyists are warning Democrats that if Mr. Obama keeps attacking Wall Street 'fat cats,' they may fight back by withholding their cash."); *see also* Hilary Potkewitz, *Hedge Fund Lobby Doubles Its Washington Spending,* CRAIN'S NEW YORK BUSINESS (Apr. 1, 2010), http://www.crainsnewyork.com/article/20100401/FREE/100409987 (reporting on hedge fund lobbying, noting "[t]he hedge fund lobby, called the Managed Funds Association, doubled its spending during the last three months of 2009 . . . The MFA strategically sprinkled more than $1 million around Washington in

Currently, the Chairman of the Senate Banking Committee, Christopher Dodd, announced a Democrat drafted proposal due to the breakdown of bipartisan negotiations.[161] That breakdown seemed to relate to disagreements between Democrats and Republicans over the consumer protection agency and the Exemption.[162] In a recent article, SEC chairman Mary L. Shapiro warned that under the new Dodd bill, stronger swap transparency and clearing is necessary to avert future crises.[163] There is also little indication that the Dodd proposal, if it were to pass in its current form, would eliminate any Derivative exemptions.[164]

V. CONCLUSION

The Crisis tide has washed away the facade of an efficient Derivative market where sophisticated parties rationally invest in financial products whose prices invariably reflect all available

---

the fourth quarter, compared to just $520,000 spent during the same period in 2008.").

161. *See* Sewell Chan, *Democrats Push Ahead on Finance Bill*, N.Y. TIMES, Mar. 12, 2010, at B1, *available at* http://www.nytimes.com/2010/03/12/business/12regulate.html?ref=business#http://www.nytimes.com/2010/03/12/business/12regulate.html?ref=business#http://www.nytimes.com/2010/03/12/business/12regulate.html?ref=business#.

162. *Id.* (reporting on Republican Senator Bob Corker, noting "Mr. Corker revealed several areas that remained in dispute at the point that Mr. Dodd announced that he would move ahead on his own. One of them, he said, was the extent to which banks would be exempt from new requirements for greater transparency in the trading of derivatives.").

163. *See* Mary L. Shapiro, *Stronger Regulation Would Help Bring Financial Swaps Out of the Shadows*, THE WASHINGTON POST, (Apr. 2, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/04/01/AR2010040102801.htmlhttp://www.washingtonpost.com/wp-dyn/content/article/2010/04/01/AR2010040102801.htmlhttp://www.washingtonpost.com/wp-dyn/content/article/2010/04/01/AR2010040102801.html ("First . . . [a]s written, the Senate legislation unnecessarily complicates matters by creating an arbitrary line based on the number of securities in a swap. This would invite users to engineer products to exploit differences in regulation policies . . . . Second, bring more transparency to this shadow market . . . . Third, maximize the use of clearinghouses and exchanges in transactions involving swaps where possible.").

164. *See* Chan, *supra* note 162; *see also Summary of the March 15, 2010 Draft of the Restoring American Financial Stability Act, Introduced by Senator Christopher Dodd (D-CT)*, DAVIS POLK & WARDELL LLP, at 19 (Mar. 17, 2010), www.sifma.org/legislative/pdf/Dodd-03152010-overview.pdf (noting that the draft bill excludes foreign exchange forwards and swaps from regulation, and also excludes positions held for "hedging commercial risk.").

information in the marketplace; the sea change however, has not surfaced. Political posturing and vast amounts of lobbying dollars continue to abate any real transformation of Derivative markets, while banker bonuses reach record levels and the U.S. economy remains on questionable footing.

Although bills in both legislative houses will address some of the broader Derivative regulation issues created by the CFMA, significant loopholes exist that will offer market participants an incentive to restructure their transactions to fit within those exemptions. Furthermore, based on the current fractured political system and unrelenting financial industry lobbying, it is unlikely that the Senate Bill will even pass in its current form.

In sum, the velocity of modern information renders market lessons inert at an increasingly rapid pace,[165] resulting in a scenario where market crisis lessons dissipate rapidly while the duration

---

165. *See,e.g.,* Larry Elliot & Heather Stewart, *Bubble Trouble: Have Prices Already Risen Too Fast Too Soon?*, THE GUARDIAN (Nov. 14, 2009), http://www.guardian.co.uk/business/2009/nov/14/bubble-fears-as-asset-prices-jump (reporting on new asset bubbles emerging from worldwide fiscal stimulus and quantitative easing, noting "[a]round the world, asset prices are booming. Relief that the global economy has avoided the Armageddon feared in March, combined with large dollops of virtually free money, have helped put a smile back on the faces of the speculators. Too big a smile, according to some experts, since the buoyancy of asset markets is not reflected in the real economy . . . . As share prices roar ahead, the question is: are policymakers trying to solve the problems caused by one of the biggest bubbles in history by pumping up another speculative frenzy?"); s*ee also* Nouriel Roubini, *Mother of All Carry Trades Faces Inevitable Bust*, FINANCIAL TIMES (Nov. 1, 2009) http://www.ft.com/cms/s/0/9a5b3216-c70b-11de-bb6f-00144feab49a.html?nclick_check=1 (warning that the dollar has replaced the Yen as the center of the global "carry trade," whereby investors garner in excess of forty percent returns by taking advantage of quantitative easing and buying risky foreign assets that are currently inflated by worldwide fiscal stimulus.); *see also* Nelson D. Schwartz & Louise Story, *Pay of Hedge Fund Managers Roared Back Last Year*, N.Y. TIMES, Apr. 1, 2010, at B1, *available at* http://www.nytimes.com/2010/04/01/business/01hedge.html?hp (reporting on the 2009 pay of hedge fund managers, noting: "[b]ut in a startling comeback, top hedge fund managers rode the 2009 stock market rally to record gains, with the highest-paid 25 earning a collective $25.3 billion, according to the survey, beating the old 2007 high by a wide margin."); *see also* Kate Kelly, Tom McGinty & Dan Fitzpatrick, *Big Banks Mask Risk Levels,* WALL ST. J. (Apr. 8, 2010), http://online.wsj.com/article/SB1000142405270230483010457517228084893898.html?mod=WSJ_Markets_MIDDLETopNews ("[m]ajor banks have masked their risk levels in the past five quarters by temporarily lowering their debt just before reporting it to the public, according to data from the Federal Reserve Bank of New York.").

between crises decreases.[166] Moreover, due to the sophistication and interdependency of modern markets, crises also become increasingly dangerous and expensive. If we cannot realize reform in Derivative markets soon, the lessons of the Crisis will fade into the distance and any hope of regulation will be politically untenable. That course of action will severely impair the U.S. and global economic future: in that possible future scenario, it is not a question of "if" another financial catastrophe will emerge, but "when."

166. *See, e.g.,* Robert Kuttner, *The Bubble Economy*, THE AMERICAN PROSPECT (Sept. 24, 2007), http://www.prospect.org/cs/articles?article=the_bubble_economy (reporting on financial bubbles, noting "[i]ndeed, until Congress dismantled financial regulation, the Fed was not called upon to mount these heroic rescues, which have become so common in recent years . . . [b]ut during the past quarter-century, as deregulation has turned the economy into a casino, the Federal Reserve has had to mount major rescues at least six times.")