

CURRENT UNITED STATES CREDIT DEFAULT SWAP REGULATORY INITIATIVES: A NEW WORLD STANDARD OR JUST A PLOY?

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I. INTRODUCTION

In recent years, the global financial market has seen an abundant increase in the use of credit derivatives; more specifically, the use of credit default swaps (CDSs).¹ Investors wanted higher returns on their investments while simultaneously reducing or maintaining the same risk exposure, so in came the CDS contracts. CDSs permitted investors to increase expected returns while limiting additional risk exposures by protecting against debt default.² Due to globalization, the international capital markets have grown to incredible levels, allowing for CDS transactions to occur daily when the parties involved have never met and reside on opposite sides of the world. The assortment and amount of these CDS transactions take many forms because the market is over-the-counter (OTC) with minimal regulation, either national or international regulation. This lack of regulation is what raises concerns regarding the CDS market, especially since the onset of the 2007–08 global financial crisis.³

Prior to the financial crisis, government officials and business persons have expressed aversion to the use of financial derivatives, including credit derivatives such as CDSs. A famous quote, in 2004, by the largest shareholder and CEO of Berkshire Hathaway, Warren Buffett, articulates his opposition to the financial derivatives market, “[I] view [derivatives] as time bombs, both for the parties that deal in them and the economic system In [my] view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”⁴ While some completely disagree with the use of derivatives, many agree that

1. See International Swaps and Derivatives Association (ISDA), Market Survey, <http://www.isda.org/statistics/pdf/ISDA-Market-Survey-historical-data.pdf> (last visited July 19, 2009). The beginning of 2001 had \$631.50 billion in outstanding CDS contracts and the end of 2008 had \$ 38.56 trillion in outstanding CDS contracts, signifying a 6006 percent growth rate in the CDS market over an eight-year period.

2. Terry Young, Linnea McCord & Peggy J. Crawford, Credit Default Swaps: The Good, the Bad, and the Ugly 1 (2009) (unpublished paper, prepared for the Ninth Annual IBER & TLC Conference Proceedings 2009), available at http://www.cluteinstitute.com/Programs/Las_Vegas_2009/Article%20356.pdf (last visited Aug. 3, 2009).

3. See, e.g., Colin Barr, *The Truth About Credit Default Swaps*, FORTUNE/CNNMONEY.COM, March 16, 2009, <http://money.cnn.com/2009/03/16/markets/cds.bear.fortune/index.htm> (last visited July 19, 2009).

4. 2002 Annual Report (Berkshire Hathaway Inc., Omaha, NE), Feb. 2003, at 13–15, available at <http://www.berkshirehathaway.com/2002ar/2002ar.pdf> (last visited July 19, 2009).

derivatives are beneficial for the marketplace, but rather just need comprehensive oversight and regulation.⁵

The international financial markets, particularly the CDS market, have grown to incredible levels at a rapid rate, yet the regulatory framework has lagged well behind the financial innovations. Because regulation has not developed as fast as financial markets, the global economy and individual investors are severely exposed to potential large economic losses and abuses. The current crisis is thought to have occurred because of a “divergence between domestic regulatory structures and the realities of global finance.”⁶

This Note has five main purposes. The first is to introduce the basics of CDSs, how they came to be a dominant financial instrument, the benefit and risks of these instruments, and their dispersion into the international marketplace. Second, it will discuss the lack of regulation of the CDS market prior to the global financial crisis of 2007–08. Third, it analyzes the current recommendations from various sources as to how the CDS market should be regulated from the current date forward and the effects of these new regulations. The fourth part contains an examination of the eight pending pieces of legislation in the U.S. Congress. Finally, the Note makes recommendations on the most efficient way to regulate CDSs to ensure financial stability and avoid future financial crises through strict oversight of the CDS market.

II. HISTORY OF THE CDS MARKET

A credit derivative is a financial derivative product⁷ which isolates a specific credit risk and then transfers this risk to a party willing to hold it; where credit risk is the risk that a borrower of money will not repay its obligation. The credit derivative alleviates the transferor of risk while placing the risk onto an obligor, who will hold the risk for some specified time for a fee from the transferor. Note that with a credit derivative, one

5. See, e.g., Rene M. Stulz, *Should We Fear Derivatives?*, J. OF ECON. PERSP., Vol. 18, No. 3, 170 (2004) (noting that proponents of CDSs praise their ability to spread risk and increase liquidity in credit markets, while the critics warn that an event could trigger a derivatives tsunami that could bring all of the major banks down and cause a burst in world credit markets).

6. Douglas W. Arner, *The Global Credit Crisis of 2008: Causes and Consequences*, 43 INT’L LAW. 91, 97 (2009).

7. A financial derivative product is commonly defined as a finance instrument which derives its value from some other referenced asset, liability, index, event, contract, condition, or other financial instrument. The most common examples of a financial derivative product are futures, options, forwards, and swaps.

party's loss is the other party's gain because a credit derivative never eliminates risk, but only transfers the credit risk and does not create wealth.⁸

These instruments are unique because the transferor may trade the credit risk to any obligor separately from the reference asset that creates the credit risk. What this means is that the credit derivative detaches the risk imbedded in an asset from the expected returns from holding the asset; enabling the market to freely trade credit risk completely separate from assets. Thus, the value of a credit derivative greatly depends on the value of the underlying reference asset, and the underlying asset's value is derived largely from market forces.⁹

A CDS contract is the most popular type of credit derivative, which focuses on transferring the risk of some specified negative credit event, usually a default on the underlying reference asset, to another party.¹⁰ CDSs are used to hedge or speculate against particular credit risks, primarily default on some underlying asset.¹¹ The CDS seller (protection seller) acquires the risk of the credit event from the CDS buyer (protection buyer) because the protection buyer pays a fee to the protection seller for carrying the risk for some specified timeframe.¹² The debtor (reference entity), the issuer of the underlying asset, is typically not a party to the CDS contract, and most times is not even aware of the CDS transaction.

8. See Stulz, *supra* note 5, at 186–87 (discussing the fundamental characteristics of credit derivatives and their increasing roles in the credit markets).

9. See Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 706–07 (2002) (discussing how a credit derivative is capable of separating credit risk from an asset, bond, commodity, index, debt, or other economic indicator so that the credit risk can be transferred to another entity).

10. André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 150–51 (2000). The author notes that “reference assets” typically include bank loans, corporate debt, trade receivables, emerging market and municipal debt, and convertible securities, as well as the credit exposure generated from other derivatives-linked activities like collateralized debt obligations.

11. There are three standard types of CDS contracts: (1) a single-name CDS which is based on one underlying, reference obligation or entity; (2) a multi-name CDS which is based on more than one underlying, reference obligation or entity; and (3) an index CDS which is based on a grouping of typically more than 100 reference obligations or entities. See U.S. GOV'T ACCOUNTABILITY OFFICE, TESTIMONY BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES, GAO–09–397T, SYSTEMIC RISK REGULATORY OVERSIGHT AND RECENT INITIATIVES TO ADDRESS RISK POSED BY CREDIT DEFAULT SWAPS 4 (Mar. 2009).

12. Scheerer, *supra* note 10, at 150–51. The author notes the typical parties to these CDS contracts include commercial banks, insurance companies, corporations, money managers, mutual funds, hedge funds, and pension funds.

Therefore, the credit worthiness of the debtor is the main motivating force behind the price of the CDS contract.¹³

Once a publicly verifiable negative credit event occurs,¹⁴ the CDS contract must be settled in one of two methods: physical or cash settlement. During a physical settlement, the protection buyer is required to transfer the underlying reference asset to the protection seller in exchange for the protection seller's credit default payment, which equals the entire face (par) value of the reference obligation.¹⁵ During a cash settlement, the protection buyer keeps the underlying reference asset, but rather the protection seller's default payment is equal to the difference between the reference obligation's face value and some prearranged amount, typically the current market (recovery) value of the reference obligation.¹⁶

As mentioned previously, the majority of CDS contracts are traded on the OTC market. The OTC market consists of private parties entering into CDS contracts directly with one another, so the contract's terms are formulated to fit each party's needs with little standardization.¹⁷ Thus, CDS transactions can vary greatly being that parties directly negotiate with one another as to the details of each contract. Because of the unlimited variations of any one contract, CDSs are not traded through an intermediary exchange, nor standardized or regulated by any governmental agency. Essentially, almost every term of a CDS contract can be negotiated and tailored to the parties' specifications, making their applicability almost endless.¹⁸

The CDS contract, as we know and use it today, was invented in 1997 by Blythe Masters of JP Morgan.¹⁹ The intent was to create a financial

13. See Feder, *supra* note 9, at 708–11 (discussing the underlying reference entity's typical role in the CDS transaction).

14. See Scheerer, *supra* note 10, at 157. The author notes that the protection seller makes no payment until "there is a default as defined in the CDS contract which may include, for example, a bankruptcy, cross-acceleration, downgrade of the reference asset or its issuer, repudiation or moratorium, restructuring or payment default." *Id.*

15. Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3097–98 (2008).

16. *Id.* at 3098.

17. 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, 1375 (2008) (discussing the OTC market for CDS transactions and the essentials of the OTC derivative market).

18. See *id.* at 1375–76.

19. David Teather, *The Woman Who Built Financial 'Weapon of Mass Destruction'*, GUARDIAN.CO.UK (U.K.), Sept. 20, 2008, <http://www.guardian.co.uk/business/2008/sep/20/wallstreet.banking> (last visited July 20, 2009).

derivative that could remove risk from companies' balance sheets, thus separating the credit default risk on issued loans from the actual loans themselves.²⁰ Thus, the CDS could remove the risk and have it moved to an off-balance sheet vehicle, clearing the company of having default risk on its balance sheet. Financial institutions, mainly banks, argued that by trading CDS contracts, they had spread their credit risk elsewhere and, therefore, needed lower monetary reserves to protect against any loan defaults. Regulators agreed and conceded in pursuing or enforcing regulations, so bank loans increased and the CDS market expanded rapidly.²¹

The OTC financial derivatives market is currently the largest financial market in the world, nominally valued at \$591.963 trillion at the year-end 2008.²² As of year-end 2008, the outstanding notional amount of CDS contracts worldwide is estimated at \$41.868 trillion, down from its peak value of \$57.894 trillion at the year-end of 2007.²³ In comparison, 2008 year-end, the worldwide stock market was valued at \$32.132 trillion,²⁴ the worldwide bond market, including all private and sovereign issued bonds, was valued at \$83 trillion,²⁵ and the nominal gross domestic product (GDP) of global economy was valued at \$60.115 trillion.²⁶ Furthermore, the notional value of the CDS market is more than seven times larger than the \$6.2 trillion in outstanding U.S. corporate debt.²⁷

Although there are several benefits for CDS contracts in the marketplace, the most common rationale for CDSs is the overall ability to distribute credit risk throughout the global markets because parties buy and sell the credit risks that they are willing to possess.²⁸ Therefore, it is argued

20. *Id.*

21. *Id.*

22. BANK FOR INTERNATIONAL SETTLEMENTS, MONETARY AND ECONOMIC DEPARTMENT, OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2008 7 (May 2009), available at http://www.bis.org/publ/otc_hy0905.pdf?noframes=1 (last visited July 21, 2009).

23. *Id.* at 10; BANK FOR INTERNATIONAL SETTLEMENTS, MONETARY AND ECONOMIC DEPARTMENT, OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2007 10 (May 2008), available at http://www.bis.org/publ/otc_hy0805.pdf?noframes=1 (last visited July 21, 2009).

24. Bloomberg, World Market Cap Chart (2009), <http://www.bloomberg.com/apps/cbuilder?ticker1=WCAUWRLD%3AIND> (last visited July 20, 2009).

25. INTERNATIONAL FINANCIAL SERVICES LONDON, BOND MARKETS 2009 1 (July 2009), available at <http://www.ifsl.org.uk/output/ReportItem.aspx?NewsID=287> (last visited July 20, 2009).

26. The World Bank, World Development Indicators Database, Gross Domestic Product 2008, July 1, 2009, <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (last visited July 21, 2009).

27. See Young, McCord & Crawford, *supra* note 2, at 1.

28. See Scheerer, *supra* note 10, at 150–51. The author notes several rationales for why a party may be interested in buying or selling a CDS contract. The protection buyer may want to reduce

that CDSs act as shock absorbers because credit risks are spread amongst many institutions around the world, limiting the concentration of losses.²⁹ Another benefit, or so it is argued, is that the CDS market increases liquidity and access to capital because CDSs permit banks to transfer risk, increasing a bank's ability to lend more money into the economy.³⁰ Other typical advantages are the CDSs capacity to increase investors' ability to achieve higher payoffs in excess to other forms of investments of the same amount because the CDS purchaser does not need to own the underlying reference asset. Further, CDS contracts may be combined to create an extensive array of risk portfolios depending on the investor's risk appetite.³¹

One can think of a CDS contract as acting similar to insurance for credit default events; one party buys insurance—the CDS contract—through a premium payment, against an unknown negative credit event in the future.³² If the unknown credit event occurs, the seller of the insurance—the CDS contract—is obligated to pay compensation to the buyer according to the contract's terms. But if the credit event fails to occur, the seller keeps the premium payment and the contract expires. However, the CDS market is not regulated like the insurance industry, although CDSs appear to have similar characteristics as insurance contracts.³³

The three principal differences, although there are certainly more,³⁴ between a CDS contract and an insurance contract are, first, the protection buyer under a CDS need not own the underlying reference asset, or otherwise have any insurable interest in that asset. Second, the protection buyer under a CDS need not have to suffer any loss in order to recover on

exposure to risk while maintaining relationships that may be endangered by selling its loans, reduce or diversify illiquid exposures, or reduce exposure while avoiding adverse tax or accounting treatment. The protection seller may want to diversify credit exposures, get access to credit markets which are otherwise restricted by internal policy or off-limits by regulation, or arbitrage pricing discrepancies resulting from mispricing in between markets.

29. Wynkoop, *supra* note 15, at 3096–99.

30. *Id.* at 3099.

31. *Id.*

32. See *Merrill Lynch Intern. v. XL Capital Assur. Inc.*, 564 F.Supp.2d 298, 300 (S.D.N.Y. 2008).

33. See generally Andrea S. Kramer, Alton B. Harris, & Robert A. Ansehl, *The New York State Insurance Department and Credit Default Swaps: Good Intentions, Bad Idea*, J. TAX'N & REG. FIN. INSTITUTIONS, Vol. 22, No. 3 (Jan./Feb. 2009).

34. For an in-depth analysis of all the differences between a CDS and insurance contract, See generally 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 (2007).

the CDS contract.³⁵ Third, the protection buyer or seller under a CDS could transfer the CDS contract to another party through assignment or novation, where an insurance contract is considered a personal contract and nontransferable.³⁶ As stated by the United States Court of Appeals, Second Circuit, "CDS agreements are thus significantly different from insurance contracts . . . [CDS contracts] 'do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation.'"³⁷

While a CDS transaction transpires exclusively between financial institutions and other sophisticated parties, insurance is for individual consumers like you and me.³⁸ Because CDS contracts are not regulated under insurance laws, the parties engaged in the CDS market do not need to meet any capital requirements, such as those required of insurance providers.³⁹ Further, in addition to the aforementioned differences between the CDS market and insurance industry, there are other differences in tax, accounting, bankruptcy, and in regulatory jurisdiction.⁴⁰

The major users of CDS contracts consist of banks, pension funds, mutual funds, insurance companies, hedge funds, and private investment funds. These institutions fall under three major groups of users: hedgers, speculators, and arbitrageurs.⁴¹ Due to globalization, the array of financial institutions involved with CDS transactions are not confined to national borders. The recent financial crisis of 2007–08 exemplifies this interconnectivity of financial institutions throughout the world, especially because this is the world's first true global financial crisis.⁴²

35. Mark Garbowski, *Credit Default Swaps: A Brief Insurance Primer* (Anderson Kill & Olick P.C., New York, NY), Jan. 2009.

36. See Schwartz, *supra* note 34, at 191–92.

37. Aon Financial Products, Inc. v. Société Générale, 476 F.3d 90, 96 (2d Cir. 2007) (citing to Br. of *amicus curiae* Int'l Swaps and Derivatives Ass'n, Inc. (ISDA), at 7).

38. Schwartz, *supra* note 34, at 201.

39. Garbowski, *supra* note 35.

40. *Id.*; See also Arthur D. Postal, *Credit Default Swap Belong Under Supervision of States*, NATIONAL UNDERWRITER, PROPERTY & CASUALTY 7, 33 (Feb. 23, 2009); Chris McMahon & Daniel P. Collins, *CDS Regulation Battle*, FUTURES 1 (Dec. 1, 2008). The aforementioned articles discuss why CDS contracts have not been subject to state insurance regulations and explain the current debate as to which federal agency has jurisdiction over the CDS market, either the Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), or Federal Reserve Bank (FRB).

41. See Feder, *supra* note 9, at 717.

42. Mark Landler, *I.M.F. Puts Bank Losses from Global Financial Crisis at \$4.1 Trillion*, N.Y. TIMES, April 22, 2009, at A6. This article estimates that banks and other financial institutions face aggregate losses of \$4.05 trillion in the value of their holdings as a result of the current financial crisis,

Although CDSs are certainly not the sole cause of the financial crisis, they assisted in creating the conditions for a financial meltdown and may exacerbate the crisis into the future.⁴³ CDSs gained popularity with the growth of securitization of loans and other debt instruments.⁴⁴ The securitized debt is often pooled together into a mortgaged backed security (MBS), which pulls together and balances underlying loans of various credit qualities, thus separating the risks from the debt instruments.⁴⁵ So, securitization permits credit risk to be spread amongst a wide group of investors and reduces the risk exposure by the financial institution holding the assets or debt itself.⁴⁶ However, the fundamental problem is that these MBSs are complex instruments with most investors not understanding the risk imbedded within them, plus the international market is entirely unregulated. Therefore, banks were able to transfer the credit risk of their debt and assets throughout the global economy, which encouraged banks to increase loans, overextend credit, and acquire enormous risks, which slowly spread to different institutions worldwide by use of the MBSs and CDSs.⁴⁷

CDSs boomed as a way to balance all the credit risks formed by the newly created securitized assets, collateralized debt obligations (CDOs) and MBSs, by hedging or providing default protection in case the underlying obligation failed.⁴⁸ Essentially, the CDS contract was viewed as a form of “insurance” against default of the underlying asset or debt instruments.⁴⁹ For example, a CDS contract will be purchased to offset the credit risk of mortgage defaults within the MBS; so the CDS is a security net against negative credit cycles and defaults.⁵⁰ Thus, a bank in California can issue MBSs to a pension fund in the European Union, who in turn purchases CDS

with \$2.07 trillion of the losses held by United States institutions. This monetary loss, mainly carried by U.S., Western European, and Japanese institutions, has caused crises in emerging market economies, principally Eastern Europe and Latin America.

43. Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L. J. 77, 79–82 (2008).

44. *Id.* at 80–81. Banks in the United States were operating an “originate-to-distribute” loan model, making residential mortgages to many borrowers for the purpose of selling these mortgages to investors by using securitization techniques. The incentives of banks were to make as many loans as possible and then distribute the risk of these loans to investors while not having to retain a sufficient portion of the credit risk themselves. Hence, the boom in sub-prime mortgages that were securitized and sold throughout the world, and the eventual default on many of these loans.

45. *Id.* at 82–83.

46. *Id.* at 80.

47. *See id.* at 80–82.

48. Unterman 2008, *supra* note 43, at 89–90.

49. *See* Young, McCord & Crawford, *supra* note 2, at 3.

50. *Id.* at 90.

contracts from an insurance company in Japan, who in turn buys CDS contracts from an investment bank in New York, and so on. The most recent purchase of a CDS is systemically linked to the original issuance of the MBS, demonstrating the intricately linked CDS market as well as international financial markets. These transactions are not regulated by an international agency, and are minimally, if at all, regulated by national governments. This process of hedging aids the exposed entities in protecting themselves from a loss in the case that a negative credit event occurs which affects the reference obligation.⁵¹

Outside of using CDSs as a way to hedge against credit risks, they are used to speculate on the default of a reference entity or asset, and also to execute arbitrage strategies. Speculators are entities that buy and sell CDSs without owning the underlying reference asset, and thus lack having a true exposure to the risks of the underlying asset, because the speculator believes the market will move in a certain direction or certain credit events will occur. Essentially, speculators place bets on beliefs of how the financial markets will move in the future and the market's results on the underlying reference asset, entity, or obligation, but never buy or hold the reference asset, entity, or obligation.⁵² Arbitragers will buy a CDS contract in one market and simultaneously sell the same CDS in another market, accordingly to exploit a difference in the prices for the CDS contract in different markets due to pricing inefficiencies.⁵³ Because speculators and arbitragers do not own the underlying reference asset, these CDS market participants trade CDSs in the short-term, bringing liquidity and more accurate risk pricing to the OTC derivative marketplace.⁵⁴

An example of a CDS transaction follows. Pension Fund P owns a bond from Corporation C. Pension Fund P is concerned that Corporation C may have financial problems and default on the bond; so Pension Fund P purchases a CDS from Bank B. The CDS contract asserts that if Corporation C defaults on the bond, Bank B will guarantee the full face value of the bond. Now to protect itself from the bond default risk, Bank B purchases a CDS from Investment Bank I with Corporation C's bond as the underlying reference asset, although Bank B does not own a Corporation C bond. What is more, Hedge Fund H, which has no connection to any of these entities, believes that Corporation C and Investment Bank I are not financially healthy. Hedge Fund H decides to bet against these two entities by using CDSs. Hedge Fund H obtains two CDSs from Reinsurance

51. See Feder, *supra* note 9, at 717.

52. See *id.* at 719–20.

53. See *id.* at 720–21.

54. *Id.* at 717–21.

Company R, one CDS for Corporation C's bond and one CDS for a security issued by Investment Bank I.

Hedge Fund H wants both Corporation C and Investment Bank I to move into insolvency so it can collect on its two CDS contracts. As Corporation C and Investment Bank I begin to show signs of insolvency, Hedge Fund H will start selling CDS contracts on these two entities, C and I, because as an entity grows closer to bankruptcy, the price of a CDS contract on that entity increases, being the cost of a credit event increases in regards to the protection seller. Thus, Hedge Fund H can sell two identical CDSs that it currently owns to earn a profit because the two CDSs it owns cost less to hold than the two CDSs it sold. This means the four total CDSs that Hedge Fund H is currently a party of will hedge one another, making Hedge Fund H almost completely safe from the credit risks of the entities, yet it profits from price differentials for identical CDS contracts on the same entities and assets, but Hedge Fund H has no connection with any of the aforementioned entities.

The greatest problem arises when one entity becomes a party to enough CDS contracts that a failure to be able to satisfy all its obligations would create a chain reaction to all other entities involved. This would send a shock wave into the entire global economic system; and because CDS contracts are traded on the OTC market, financial markets do not know which entities own which CDSs, the risks these entities currently hold, and the monetary amount of each CDS transaction.⁵⁵

III. RISKS INHERENT WITHIN THE CDS MARKETPLACE

The CDS market is designed to reduce an entity's exposure to credit risks by permitting the risk holding entity to unbundle this credit risk from the asset or debt, then sell the risk to a party willing to possess it. Although the CDS transfers the credit default risk to another party, the CDS contract inherently generates several risks of its own.⁵⁶ These customary CDS risks include market, credit including counterparty and settlement risks, liquidity, operational, legal, systemic, moral hazard, concentration, and default. However, intrinsic risks in a CDS transaction will vary on a case-by-case basis due to the large variation in types of transactions,⁵⁷ especially international CDSs. Prior to discussing current and potential regulations in

55. Alex Blumberg, *Unregulated Credit Default Swaps Led to Weakness*, NATIONAL PUBLIC RADIO, Oct. 31, 2008, available at <http://www.npr.org/templates/story/story.php?storyId=96395271> (last visited July 21, 2009).

56. See Feder, *supra* note 9, at 721–31.

57. See Scheerer, *supra* note 10, at 162–75.

the CDS marketplace, it is crucial to understand the inherent risks of this OTC derivative.

A. Market Risk

Market risk is common to all financial derivatives because any party to a CDS contract faces the possibility that the face value of the contract will change with changes in the conditions of the general marketplace.⁵⁸ For example, a party selling a CDS contract, the protection seller, encounters the risk that some action in the marketplace will have a negative effect on the underlying reference entity, thus devaluing the reference asset and increasing the likelihood that the protection seller will have to settle the contract.⁵⁹

B. Counterparty and Settlement Risks

Every party to a financial derivative confronts the risk that the counterparty will fail to meet the terms of the contract. This CDS credit risk can be split into counterparty and settlement risks. Counterparty risk arises because the counterparty to the CDS contract may become insolvent sometime prior to the settlement date stated in the contract. The failures of the counterparty to remain solvent does not necessarily suggest the blameless party will lose an amount equal to the face value of the reference asset. Rather, the blameless party's loss is equal to the cost it suffers to replace the original CDS with the same CDS from another party for the remaining timeframe.⁶⁰ Counterparty risk grows ever more complicated once the CDS is issued into the market because the seller or the buyer may choose to trade the contract to other parties. Thus, a CDS may have several different counterparties over its lifetime, making the task of tracking and assessing counterparty risk highly intricate and potentially inaccurate.⁶¹

There are two valuable tactics for minimizing counterparty risks. First, netting⁶² permits the parties to terminate outstanding transactions between each other when one counterparty becomes insolvent, rectifying the parties' payables and receivables. However, the contractual terms for

58. See Feder, *supra* note 9, at 722.

59. *Id.*

60. *Id.* at 723.

61. Rosa Abrantes-Metz & Cathy M. Niden, *The Information Content of Credit Default Swap Prices*, 14 No. 18 ANDREWS DERIVATIVES LITIG. REP. 1, 2 (2008).

62. Netting is the process by which an entity may cancel out a positive value and a negative value, in part or in whole, in order to decrease the amount of exposure the entity has in the market. There are three major types of netting: settlement, novation, and close-out.

the netting arrangement must be legally enforceable, allowing parties to exchange counterparty risk for legal risks. Either way, netting is highly beneficial because it condenses several payments into one while simultaneously reducing the parties' outstanding capital charges.⁶³ Second, credit support provides collateral, such as a reserve of money paid by the parties, as a guarantee in case of the counterparty's failure. While credit support does not eradicate the counterparty risk, it provides a minimal safety net that the parties know exists to protect a certain value of the CDS transaction in the case of default.⁶⁴

Settlement risk is the risk that one of the parties will meet the CDS contractual requirements on the settlement date, while the other party will not. Settlement risk can endanger the liquidity of the compliant party because the complaint party may need the CDS payment in a timely manner in order to pay other obligations. This will arise in the international CDS market because the parties may reside in different time zones, delaying the transferring of funds between bank accounts.⁶⁵ Similar to the counterparty risk, settlement risk may be reduced by the use of netting all the payables and receivables of the parties on the given settlement date; therefore reducing the total amount one party will owe to the other.⁶⁶

C. Liquidity Risk

Another inescapable risk is when a party will not be able to transact in the CDS market without experiencing extraordinary costs due to a lack of immediately available resources or other parties to transact. This liquidity risk can be divided into two subtypes: funding liquidity and market liquidity risks. Funding liquidity risk emerges when a party cannot meet its payment obligations under the CDS due to a temporary cash shortage. Market liquidity risk arises when a party is unable to terminate the CDS transaction prior to the maturity date. Market liquidity risks primarily occur because the CDS contract is not assignable or disallows novation.⁶⁷

D. Operational Risk

Operational risk is the possibility that parties holding a CDS contract will improperly measure, monitor, or control the risks that the CDS contract, as well as financial markets in general, manifests and creates. So

63. Feder, *supra* note 9, at 723–24.

64. *Id.* at 724.

65. *Id.* at 724–25.

66. *Id.* at 725.

67. *Id.* at 725–26.

to minimize operational risks, the parties must calculate their exposure, ability, and desire to carry the risk.⁶⁸ To ensure that entities engaged in CDS transactions regularly and properly address their operational risks, mandatory standards and oversight will guarantee compliance, thus minimizing these operational risks.

E. Legal Risk

Because CDSs are new to the financial industry and lack both national and international regulation, the CDS market runs the risk that new laws and legislation will not be enforced properly or efficiently. Also, parties risk that the contracts will be voided or not honored. This risk is evident in the current financial market climate. With a rise in financial litigation and pressing concerns for new regulations, the future of the CDS market is not quite certain. The last decade illustrates what happens when the legal system fails to expand and innovate at the same rate as the financial markets. The legal risks arise from the CDS contract and the counterparty, with risks and costs intensifying when dealing internationally because of differences in legal regimes.⁶⁹

F. Foreign-Exchange Risk

International CDS contracts contain a risk not inherent in domestic CDS transaction, foreign-exchange risk. Foreign-exchange risk is the risk of an investment's value changing due to changes in currency exchange rates, or the risk that an investor will have to close out a position in a foreign currency at a loss due to an adverse movement in exchange rates.⁷⁰ For example, if money must be converted to another currency so the protection buyer can make the premium payments or so the protection seller can make the settlement payments, the parties risk any changes in the currency exchange rate that could cause an increase to either of their payments or a decrease in the value of the CDS contract.⁷¹

68. Feder, *supra* note 9, at 727.

69. *Id.* at 728.

70. Investopedia, Foreign-Exchange Risk, <http://www.investopedia.com/terms/f/forenexchangerisk.asp> (last visited July 24, 2009).

71. See generally *The Recent Turmoil in the Icelandic Foreign Exchange Swap Market*, Monetary Bulletin 2008-1 (Central Bank of Iceland, Reykjavik, Iceland), Apr. 2008, available at <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=6096> (last visited July 21, 2009).

G. Systemic Risk

Since the recent financial crisis, systemic risk has been receiving a lot of coverage and discussion. Systemic risk is the risk that some trigger event will create a negative chain reaction throughout the entire financial or economic system. Essentially, some economic shock, such as an institutional failure, will disperse into the economy, causing a domino effect of negative events with widespread consequences.⁷² Regarding the CDS market, two opposing sides have emerged as to whether CDSs increase systemic risk. Critics argue that CDS transactions transfer underlying risks while simultaneously creating new risks. Therefore, the CDSs create an intricate network of transactions and risks because the CDS market is not transparent and illiquid, with the parties to the CDS transactions passing and undertaking risks that they do not fully understand and underestimate. In the worst case scenario, the failure of one entity to meet its obligations will begin a chain reaction causing an eventual collapse of the entire financial system.⁷³

On the other side, the proponents argue that CDSs pose no more of a threat than any other financial instrument. CDSs assist in transferring risk from one entity into a market among several parties who are better able and willing to carry these risks. Thus, CDSs stabilize the economy by permitting one entity with a lot of risk to disburse this risk in the market among a group of other entities, decreasing the systemic risk if one entity should fail.⁷⁴

The recent financial crisis provides us with great examples of systemic risk. For example in 2008, American International Group (AIG), the world's largest private insurance company, required a financial \$152 billion bailout by the United States federal government and to eventually be seized by the government itself, now owning an eighty percent stake in the company.⁷⁵ AIG became a large protection seller of CDSs to many institutions, mainly financial firms wanting to protect themselves from risks inherent in MBSs, boosting profits for AIG to record levels. So while all the premium payments from the CDS protection buyers went into AIG as

72. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 198 (2008).

73. Feder, *supra* note 9, at 729.

74. *Id.* at 729–31.

75. Robert O'Harrow Jr. & Brady Dennis, *Downgrades and Downfall*, WASHINGTON POST, Dec. 31, 2008, at A01, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/30/AR2008123003431.html> (last visited July 22, 2009). See also Edmund L. Andrews, *Fed Rescues AIG with \$85 Billion Loan for 80% Stake*, N.Y. TIMES ONLINE, Sept. 17, 2008, <http://www.nytimes.com/2008/09/17/business/worldbusiness/17iht-17insure.16217125.html> (last visited Aug. 2, 2009).

profit, all these outstanding CDS contracts opened AIG to billions of dollars of potential losses and payouts, upon a credit event occurrence.⁷⁶ When the housing market began to unravel in 2007 and Lehman Brothers failed in 2008, it set off a chain of events that would prove disastrous for AIG; credit rating agencies downgraded their ratings of securities that AIG had insured with the CDSs. The credit rating downgrades increased demands by AIG's CDS counterparties for billions of dollars in collateral. Thus, AIG began a desperate search for cash to meet the collateral calls under the CDSs.⁷⁷ As downgrades continued, AIG continually needed to post more collateral for the \$450 billion it wrote in CDS contracts.⁷⁸ Eventually, the federal government had to step in to save AIG from financially collapsing.⁷⁹

United States Treasury Secretary, Henry M. Paulson, concluded that AIG would not be allowed to collapse because the company was too big.⁸⁰ Eric Dinallo, the Superintendent of Insurance for the State of New York, recognized that because AIG had operated for so long at the center of the world's financial web, with so many CDS counterparties, that its collapse would be felt in every corner of the globe.⁸¹ The federal government decided that if it did not provide AIG with funds to pay for the CDS contracts, AIG's default would cause other entities expecting payments to not be able to make payments on their obligations and so on; true systemic risk in practice.⁸²

H. Moral Hazard Risk

Another inherent risk imbedded within a CDS transaction is the parties' incentives to neglect the risk of the underlying reference asset, obligation, or entity. This moral hazard suggests that a CDS will reduce an incentive to monitor or accurately appraise certain risks.⁸³ For example, a bank that makes loans and then purchases a CDS to reduce the risk of a borrower default will have a reduced incentive to monitor the loans. A bank is in the best position to screen the borrower of money and monitor the borrower's finances, but when the bank transfers the loan default risk to

76. O'Harrow Jr. & Dennis, *supra* note 75, at A01.

77. See Young, McCord & Crawford, *supra* note 2, at 4.

78. See *id.*

79. O'Harrow Jr. & Dennis, *supra* note 75, at A01.

80. *Id.*

81. *Id.*

82. *Id.*

83. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1032–33 (2007).

a third party, the bank loses this incentive to monitor the issued loans. If the third party taking on the risk does not monitor the reference obligation, CDS purchasers have an incentive to make ever more risky investments.⁸⁴

I. Concentration and Default Risks

Concentration risk is the potential for a loss when a party, usually a large financial institution, establishes a large net exposure to CDS contracts.⁸⁵ When an entity sells a large amount of CDS contracts without purchasing and holding offsetting positions, concentration risk greatly increases. This risk is evermore amplified by the fact that there is no legal requirement that the buyer and seller of CDS contracts post margin and collateral funds to ensure that either party will be able to meet obligations stipulated in the CDS. Further, a party holding a large concentrated position in CDS contracts may face financial difficulty if the condition of the financial market changes in any direction, good or bad, because certain provisions in the CDS may require increased margin or collateral posts, placing the party in financial distress with increasing liquidity problems.⁸⁶

Jump-to-default risk is the risk that the onset of a credit event for the underlying reference asset, as defined in the CDS contract, will create an abrupt change in the party's CDS exposure or financial condition.⁸⁷ As mentioned previously, a change in the financial market will alter the value of the CDS contracts, which in turn may demand that a party post additional margin or collateral amounts. Thus, if the values of the CDSs alter so drastically as to force a party to post additional funds beyond what the party is financially capable of posting, a default on the CDS contracts will likely occur.⁸⁸

IV. CURRENT UNITED STATES REGULATION OF THE CDS MARKET

The United States holds a substantial role in the global financial market. The U.S. regulation of financial markets is important because financial decisions will be based on the legal and regulatory requirements inside and outside the nation's borders. Further, the United States is known to be the largest recipient of foreign investment because it is regarded as stable, profitable, and a vigilant guardian of investor rights. It has created a

84. *See id.* at 1033–34.

85. *See* TESTIMONY BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES, GAO–09–397T, *supra* note 11, at 14.

86. *See id.*

87. *Id.* at 15.

88. *See id.*

balanced standard for liberalization and regulation, thus the United States is the leader of the financial markets and the world looks to the United States for guidance as to regulatory initiatives.⁸⁹

The current state of CDS market regulation in the United States is quite limited. The SEC chairman, Christopher Cox, stated “[t]he regulatory black hole for credit-default swaps is one of the most significant issues we are confronting in the current credit crisis, and it requires immediate legislative action.”⁹⁰ Furthermore, he declared “[t]he over-the-counter credit-default swaps market has drawn the world’s major financial institutions and others into a tangled web of interconnections where the failure of any one institution might jeopardize the entire financial system. This is an unacceptable situation for a free-market economy.”⁹¹

The Securities Act of 1933 (Act of 1933) regulates domestic securities transactions in order to protect investors and bolster market efficiency, competition, and capital formation.⁹² The Securities Exchange Act of 1934 (Act of 1934) requires, *inter alia*, the registration of security brokers and dealers with the Securities and Exchange Commission (SEC).⁹³ Further, the securities that the brokers and dealers sell must be traded on a national exchange.⁹⁴ These two federal statutes have the potential to regulate CDS contracts, however, the definition of a “security” does not include a CDS,⁹⁵ and thus a CDS escapes regulation by the SEC under these federal securities statutes.⁹⁶

89. See Unterman 2008, *supra* note 43, at 104.

90. O’Harrow Jr. & Dennis, *supra* note 75, at A01.

91. *Id.*

92. 15 U.S.C.A. § 77b(b) (West 2009).

93. *Id.* §§ 78o, 78d.

94. *Id.* § 78l(a).

95. *Id.* §§ 77b-1, 78c-1.

96. Cf. The Investment Company Act of 1940 (IC Act of 1940) codified at 15 U.S.C.A. § 80a-1 through 15 U.S.C.A. § 80a-64. The IC Act of 1940 was designed to mitigate or eliminate conflicts of interest of investment companies and securities exchanges which adversely affect the interests of the public and investors. The IC Act of 1940 regulates CDSs if an investment company makes use of a CDS contract because bank regulators have authority to intervene in an investment company’s actions to the extent the CDS transactions of the entity affects its financial health. However, the IC Act of 1940 includes exempt companies, like hedge funds, within Sections 3(c)(1) and 3(c)(7) and the regulators’ authority to intervene is limited to CDS activity deemed to pose risks to the safety and soundness of the entities regulated. Therefore, the IC Act of 1940 may or may not regulate CDS transactions depending on what type of company is entering into the contract and the risks involved. Although it may regulate certain CDSs, the CDSs used by banking institutions, the Act does not regulate the CDS market as a whole. See TESTIMONY BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES, GAO-09-397T, *supra* note 11, at 6-7.

The Commodity Exchange Act (CEA) generally regulates financial derivatives.⁹⁷ Nevertheless, a CDS contract avoids regulation under this federal statute for at least one of two definitions. First, a CDS is excluded because the CEA excludes a commodity that is a credit risk or measure, debt instrument, other measure of economic or commercial risk, or an occurrence, extent of an occurrence, or contingency that is beyond the control of the parties to the relevant contract, agreement, or transaction; and associated with a financial, commercial, or economic consequence.⁹⁸ Second, a CDS is excluded because the CEA does not apply to any agreement, contract, or transaction that is entered into only between persons that are eligible contract participants at the time they enter into the agreement, contract, or transaction; subject to individual negotiation by the parties; and not executed or traded on a trading facility.⁹⁹ Eligible parties to a CDS contract must be well capitalized, sophisticated entities like financial institutions, insurance and investment companies, and corporations.¹⁰⁰

In 2000, Congress passed the Commodity Futures Modernization Act (CFMA) to amend the CEA.¹⁰¹ Identical to the CEA, the CFMA interpreted a CDS to not be a type of security; thus not regulated by federal securities laws.¹⁰² The CFMA defines a “swap agreement” as:

[A]ny agreement, contract, or transaction between eligible contract participants . . . that provides for any purchase, sale, payment or delivery . . . that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; [or] provides on an executory basis for the exchange . . . of one or more payments based on the value or level of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind . . . in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership

97. 7 U.S.C.A. § 1a(4) (West 2009).

98. *Id.* § 1a(13).

99. *Id.* § 2(g).

100. *Id.* § 1a(12).

101. Commodity Futures Modernization Act of 2000, H.R. 5660, 106th Cong. (2000).

102. *See id.*

interest in an asset . . . or liability that incorporates the financial
risk so transferred¹⁰³

It appears clear that this definition of a “swap agreement” includes a CDS contract, but to ensure that there is no confusion, Congress explicitly classified a CDS as a “swap agreement” by stating, “any such agreement, contract, or transaction commonly known as a . . . debt swap, credit spread, credit default swap, credit swap”¹⁰⁴

There is one exception to the lack of regulation by the federal government. The SEC will be able to quasi-regulate a CDS because a CDS is a “security-based swap agreement,” meaning the swap derives at least one of its key terms from the price, yield, maturity, or volatility of a security, group of securities, or index of securities.¹⁰⁵ Therefore, under the Act of 1933 and the Act of 1934, the SEC can enforce anti-fraud, anti-manipulation, and insider trading provisions against traders of a “security-based swap agreement.”¹⁰⁶

Congress intended to create regulations that would promote innovation in the OTC derivative market, rather than have CDSs repressed because the parties to CDS transactions are sophisticated.¹⁰⁷ Consequently, the CFMA officially unregulated the CDS market under the rationale that the CDS market would self-regulate.¹⁰⁸ Since the recent financial crisis, former proponents of an unregulated CDS market have recognized the failure in this approach.¹⁰⁹

V. CURRENT INTERNATIONAL REGULATION OF THE CDS MARKET

Currently, there is no international regulatory agency that directly monitors or regulates the CDS market.¹¹⁰ Therefore, it is commonly argued

103. *Id.* § 301.

104. *Id.*

105. *Id.* Section 301 of the CFMA added sections 206A–C to the Gramm-Leach-Bliley Act of 1999. *See also* 15 U.S.C.A. §§ 77b-1, 77q, 78c-1, 78i, 78j.

106. *See SEC Issues Temporary Exemption for CDS Central Counterparties* (Sutherland, Atlanta, GA), Jan. 16, 2009, at 1. *See also* 15 U.S.C.A. §§ 77b-1, 77q, 78c-1, 78i, 78j.

107. Lynch, *supra* note 17, at 1378.

108. Thomas Lee Hazen, *Filling a Regulatory Gap: It Is Time to Regulate Over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123, 128 (2009).

109. *See id.* (noting that former Chairman of the Federal Reserve of the United States, Alan Greenspan, was once a strong supporter of permitting the financial derivatives market to self-regulate, but as of recent he has changed his opinion on derivative regulation, supporting strict regulatory oversight).

110. *See generally* Amer, *supra* note 6, at 119–34.

that the true regulators of the CDS market are the participants themselves.¹¹¹ The CDS market participants have banded together to form a trade organization known as the International Swaps and Derivatives Association (ISDA).¹¹² The ISDA has created a system of documenting, amending, and standardizing CDS transactions in a way that is flexible and robust for all market participants.¹¹³

The ISDA currently has a membership of approximately 830 institutions from over fifty-eight countries.¹¹⁴ The association was created in 1985 in order to create and promote standardized documentation for financial derivative products at a time when derivative transactions carried high transaction costs.¹¹⁵ It created bilateral Master Agreements for CDS transactions in order to facilitate the market through preventative measures, reduce costs, set international standards, and create a base structure for any OTC derivative transaction.¹¹⁶ These Master Agreements foster standardized terms to regulate the general obligations of the parties, events of default, netting, early termination, transfers and novations, currency provisions, and key definitions.¹¹⁷ Standardized terms are useful and important by reducing legal risk by providing clear and concise terminology, thus reducing the risk of incompatibility of laws between different jurisdictions.¹¹⁸ Also, standardized terms increase transparency and minimize confusion. Further, the ISDA has created a Master Agreement specifically for international transactions, used to document transactions between parties in different jurisdictions or transactions involving different currencies.¹¹⁹

111. Schwartz, *supra* note 34, at 171.

112. *Id.* Most members of the ISDA are individual or groups of banks.

113. *Id.* While the ISDA is not the only organization formed by CDS market participants, it is currently the largest and most influential in the market.

114. ISDA, Membership, <http://www.isda.org/> (follow the "Membership" tab on the left hand side of the website) (last visited July 30, 2009).

115. ISDA, About ISDA, <http://www.isda.org/> (follow the "About ISDA" tab on the left hand side of the website) (last visited July 30, 2009).

116. ISDA, Bookstore/Publications, <http://www.isda.org/> (follow the "Bookstore/Publications" tab on the left hand side of the website) (last visited July 30, 2009). The most recent Master Agreement was published in 2002. See also Clarence B. Manning, *A Derivative Primer for Corporate Counsel, or Do You Know What Your Treasurer is Doing?*, 13 No. 2 ACCA DOCKET 6, 16 (Mar./Apr. 1995).

117. See Schwartz, *supra* note 34, at 178 (citing to ISDA, 2002 Master Agreement (2002)). For more information and explanation regarding the Master Agreement's standardized terms, see Feder, *supra* note 9, at 736-47.

118. Scheerer, *supra* note 10, at 174.

119. ISDA, Bookstore/Publications, <http://www.isda.org/> (follow the "Bookstore/Publications" tab on the left hand side of the website) (last visited July 31, 2009).

These Master Agreements may be altered to the parties' specifications by the parties using an amending document called the Schedule.¹²⁰ The Master Agreement and Schedule are given effect through "confirmations," which are documents that serve as evidence of the CDS transactions.¹²¹ The typical "confirmation" for a CDS transaction confirms the CDS contract's material terms, *inter alia*, such as the reference entity, reference obligation or asset, payment structures, the credit event, settlement terms, collateral deposits, and the timeframe of the contract.¹²²

One important provision in the Master Agreement involves "close-out netting," which applies when one party to the CDS defaults or becomes insolvent. This "close-out netting" provision permits the non-defaulting to "calculate a single settlement amount by offsetting its scheduled future payment and delivery obligations to the bankrupt party against the bankrupt party's obligations to it."¹²³ Close-out netting halts a trustee or liquidator in bankruptcy to abandon CDS contracts that are harmful to the bankrupt party while insisting on performance of beneficial CDSs.¹²⁴

The Master Agreement is beneficial for CDSs in order to promote standardized documentation of the transactions. This becomes especially important when an insolvent party holds many CDSs with multiple counterparties. Rather than have to appraise each CDS separately, the Master Agreement authorizes all CDSs executed with each party to be evaluated as a net amount.¹²⁵ Also, ISDA publishes protocols, which are written contract amendments that empower the Master Agreements to

120. See Schwartz, *supra* note 34, at 178 (citing to ISDA, Schedule to the 2002 Master Agreement (2002)). See generally *2002 Master Agreement Protocol* (ISDA, New York, NY), July 15, 2003, available at http://www.isda.org/2002masterprot/masterprot_txt_form_adhrnce_letr.html (last visited July 30, 2009). The ISDA counterparties can select terms from an extensive menu to meet each party's customized situation.

121. See Schwartz, *supra* note 34, at 178 (citing to ISDA, 2003 Credit Derivative Definitions 1, Exhibit A at 61 (2003)).

122. See *id.* at 178–79 (citing to ISDA, 2003 Credit Derivative Definitions 1, Exhibit A at 61–70 (2003)).

123. See *id.* at 179 (citing to ISDA, 2002 Master Agreement (2002)).

124. *Id.* at 179. Although the close-out netting provision stops a bankrupt entity from abandoning CDS contracts, this does not guarantee that the bankrupt entity will have the funds available to pay all the CDSs outstanding. There are other creditors that have valid claims to the bankrupt entity's assets so the counterparty to the CDS may not receive the total settlement amount as stated in the CDS. See, e.g., Shannon D. Harrington & Neil Unmack, *Lehman Credit-Swap Auction Sets Payout of 91.38 Cents* (Update2), BLOOMBERG.COM, Oct. 10, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=a_zN11_Do0QM&refer=news (last visited July 30, 2009).

125. Schwartz, *supra* note 34, at 180.

respond, in a unified way, to market disturbances by giving parties equal footing in dealing with insolvent reference entities.¹²⁶

However, because CDS transactions are privately negotiated contracts on the OTC market, the terms of each CDS will vary depending on the parties; there is no mandatory requirement in a CDS contract, rather the Master Agreement is an ideal contract that the parties may choose to use. Parties often disagree as to which terms in the CDS should be standardized because each CDS party operates under different internal standards and national legal regimes.¹²⁷ Thus, the Master Agreement will likely be heavily altered, giving rise to other concerns and decreasing the value of standardized terms and definitions. Even when parties use a Master Agreement to complete a CDS transaction, the standardized terms are complex and may still give rise to ambiguity or conflict.¹²⁸ But although the full effect of standardized terms is unknown, the 2003 Credit Definitions published by the ISDA are thought to be reducing CDS contract disputes.¹²⁹

Furthermore, although the ISDA has introduced and promoted the aforementioned provisions, the ISDA does not hold regulatory authority or power over CDS participants; signifying that compliance with ISDA standards is optional.¹³⁰ Critics of the ISDA state that the association resists disclosure of CDS documentation: “[r]ecord 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.”¹³¹ So while the documentation of CDSs have become ever more standardized and synchronized, the market still manages to remain opaque because many transactions go undisclosed to the marketplace.¹³²

The ISDA’s monopolistic power over the self-regulation of the CDS market has led many to believe that the industry promotes the interests of a few major participants because leadership within the ISDA is dominated by a small amount of major participants.¹³³ Major participants try to protect

126. *Id.*

127. *See* Feder, *supra* note 9, at 741.

128. *See, e.g.,* Aon Financial Products, Inc. v. Société Générale, 476 F.3d 90 (2d Cir. 2007); Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co., 375 F.3d 168 (2d Cir. 2004).

129. Schwartz, *supra* note 34, at 173.

130. *See* Lily Tijo, Note, *Credit Derivatives: Regulatory Challenges in an Exploding Industry*, 26 ANN. REV. BANKING & FIN. L. 387, 398 (2007).

131. Partnoy & Skeel, *supra* note 83, at 1036 (citing David Wessel, *Wall Street is Cleaning Derivatives Mess*, WALL STREET JOURNAL, Feb. 16, 2006, at A2).

132. *See id.*

133. *Id.* at 1037–38.

their interest by sacrificing the market's efficiency as a whole.¹³⁴ Protecting self-interests should come as no surprise, being that is how rational participants act in the market and which may be the inherent flaw with the ISDA's self-regulation strategy. These interests are protected by developing standardized documents, terms, and definitions that exploit information asymmetries, create negative externalities, or redistribute resources. Further, major participants lack an incentive to disclose transactions or other information because broad disclosure would reduce the major participants' specialized knowledge of the CDS market, thus reducing potential profits.¹³⁵

Regulation of CDSs is based on "governance arrangements for OTC derivatives (that) are predominantly based on private sector-inspired practices of self-regulation and self-supervision."¹³⁶ Thus, the ISDA has gained significant, if not complete, control of the legal rules applicable to a CDS contract, although the ISDA's rules are not mandatory and potentially prejudicial within the CDS marketplace.

Outside of the ISDA's self-regulatory system, there is an international accord which created recommendations for national implementation of banking laws and regulations, the International Convergence of Capital Measurement and Capital Standards—A Revised Framework (Basel II).¹³⁷ The Basel II developed a framework to foster stability within the international banking system by regulating risk management practices of financial institutions. The most significant measurement required by banks under the Basel II is the "first pillar" capital equivalent. What this means is that a bank must fulfill a total capital ratio no lower than eight percent of the risk-weighted assets.¹³⁸ The risk-weighted assets standard is the bank's assets weighted according to the credit risk of the assets; which can be

134. *Id.* at 1037.

135. *See id.*

136. Paul Latimer, *Regulation of Over-the-Counter Derivatives in Australia*, 23 AUSTRL. J. OF COMP. LAW, 12 (2009) (quoting Eleni Tsingou, *The Governance of OTC Derivative Markets*, in PETER MOOSLECHNER, HELENE SCHUBERTH, & BEAT WEBER, *THE POLITICAL ECONOMY OF FINANCIAL MARKET REGULATION—THE DYNAMICS OF INCLUSION AND EXCLUSION* 186 (Edward Elgar, Cheltenham, UK, 2006)).

137. BASEL COMMITTEE ON BANKING SUPERVISION, *THE INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS—A REVISED FRAMEWORK COMPREHENSIVE (Version 2004, Updated 2006)* [hereinafter Basel II], available at <http://www.bis.org/publ/bcbs128.pdf> (last visited Aug. 1, 2009).

138. *Id.* at ¶ 40.

calculated under either one of two methods according to the Basel II, the Standardized or Internal Ratings Based approaches.¹³⁹

The need for banks to comply with Basel II's minimal capital requirements encouraged financial institutions to find a way to decrease risk exposure in order to free capital reserves. CDSs would limit the bank's downside risk by passing the credit risk of loans onto other parties, thus banks would be willing to loan out much more money expanding the economy's access to capital.¹⁴⁰ For example, a bank holding mortgages would be holding both the assets and risks of these instruments. Holding the risks meant the bank had to maintain certain levels of capital in reserves to ensure financial stability if the mortgages defaulted. Therefore, banks would transfer risks through securitized assets and CDSs. The bank could increase cash, reduce risk, and thus reduce the necessary capital reserves by selling the asset or debt's risk, thus permitting the bank to comply more easily with the Basel II.¹⁴¹ Basel II required banks to hold capital reserves when "significant credit risk has not been transferred to a third party . . . [,]"¹⁴² so the banks increased CDS usage to transfer significant credit risks to third parties, making the retention of loans less risky.

Not only did banks want to use CDSs to transfer risk, Basel II even identified CDSs as a credit risk mitigation technique. As banks began to recognize risk mitigation techniques, banks increased the use of credit derivatives, such as CDSs. A bank using a CDS does not alleviate it from needing capital reserves; rather the CDS reduces the capital reserve amount because holding a CDS for a loan is less risky than solely holding the loan.¹⁴³ Strong incentives increased the use of CDSs; however this increased usage dramatically increased the banks' exposure to counterparty risks among financial institutions while dispersing credit risks among financial institutions.¹⁴⁴ Thus, it is unlikely the banks actually reduced overall risk, but rather increased risk exposure.

139. Unterman 2008, *supra* note 43, at 119. "The 'standardized approach' is reliant upon external credit rating agencies to determine the risks associated with a financial institution's holdings. For these ratings to be accepted they must be from agencies recognized by domestic banking regulators. The 'internal ratings based approach' allows financial institutions to develop their own internal rating system based on certain stipulated guidelines." *Id.*

140. See Partnoy & Skeel, *supra* note 83, at 1024–25.

141. See Unterman 2008, *supra* note 43, at 120.

142. Basel II, *supra* note 137, at ¶ 554.

143. See Chris Kentouris, *Basel II Draws Attention to CDS Risk Management*, SECURITIES INDUSTRY NEWS, July 26, 2004, http://www.moodyskmv.com/newsevents/mc/mc07262004_sin.html (last visited August 1, 2009).

144. See Amer, *supra* note 6, at 110–11.

As with the ISDA's initiatives discussed prior, Basel II is not law but rather is a model that national regulatory regimes are encouraged to adopt. "This [Basel II] is being circulated to supervisory authorities worldwide with a view to encouraging them to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities."¹⁴⁵ Therefore, not all nations have adopted Basel II in unison; rather, regimes adopt certain portions, the whole accord, or none of it.¹⁴⁶ Also, Basel II, if adopted, only applied to commercial banks and not other financial institutions such as hedge funds, pension funds, private investment funds, insurance companies, or investment banks.¹⁴⁷ Furthermore, capital requirements underestimated the risk of CDSs and require clearer and more effective guidance to measuring and disclosing these CDS risks in the future.¹⁴⁸

VI. RECOMMENDATIONS TO OVERHAUL THE CDS MARKET

The recent financial turbulence emerged because there were too many gaps in the regulatory system where financial products operated in the shadows.¹⁴⁹ There are currently many different views on whether the CDS market necessitates regulation or oversight, and if so to what extent and how to implement it. Prior to the 2007–08 global financial turmoil, U.S. federal banking agencies issued guidance for supervising and regulating the OTC derivative market, although never mandatory rules.¹⁵⁰ The focus was on credit risk management, capital adequacy and regulatory capital reserves, and disclosure of risk.¹⁵¹ Government banking agencies declared that banks needed to include credit derivatives into their risk-based capital

145. Basel II, *supra* note 137, at ¶ 3.

146. See, e.g., FINANCIAL STABILITY INSTITUTE, IMPLEMENTATION OF THE NEW CAPITAL ADEQUACY FRAMEWORK IN NON-BASEL COMMITTEE MEMBER COUNTRIES (Sept. 2006), available at <http://www.bis.org/fsi/fsipapers06.pdf?noframes=1> (last visited Aug. 3, 2009).

147. See Aaron Unterman, *Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L. J. 53, 104 (2009).

148. See Unterman 2008, *supra* note 43, at 120.

149. COMMITTEE ON CAPITAL MARKETS REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM, RECOMMENDATIONS TO REDUCE SYSTEMIC RISK AND MAKE MARKETS MORE TRANSPARENT (May 2009).

150. See, e.g., FEDERAL DEPOSIT INSURANCE CORPORATION, SUPERVISORY GUIDANCE FOR CREDIT DERIVATIVES (Aug. 1996) [hereinafter FDIC Report]; OFFICE OF THE COMPTROLLER OF THE CURRENCY, CREDIT DERIVATIVES: GUIDELINES FOR NATIONAL BANKS (Aug. 1996) [hereinafter OCC Report].

151. Sheerer, *supra* note 10, at 179–80.

computations,¹⁵² signifying that certain credit derivatives would require the banks to hold higher levels of capital reserves for the increased risks derived from these credit derivatives. Therefore, banks were being advised by the government to hold capital reserves in relation to their risk exposure to the underlying reference assets.¹⁵³

Whether a credit derivative was considered in calculating risk-based capital reserves depended on the credit risk protection provided by the credit derivative. Banks could avoid meeting the capital reserve requirements by offsetting one credit derivative with another credit derivative. This “back-to-back” credit derivative position was used to mitigate risk by hedging credit derivatives from one entity with credit derivatives from another.¹⁵⁴

Since the commencement of the global financial crisis, governments around the world were forced to rethink the current regulatory system for financial markets, especially within the United States. Several groups in the United States and the United Kingdom have issued detailed reports addressing the financial crisis with recommendations to resolve the crisis and avoid similar future crises. The two most commonly argued regulatory transformations are the creation of a mandatory centralized clearinghouse for CDS transactions and a ban on “naked” CDSs.¹⁵⁵ The Committee on Capital Markets Regulation (CCMR) released a report in May 2009 in direct response to the financial crisis to promote effective regulation, increase investor protection through increased market transparency, and develop a global solution.¹⁵⁶

A centralized clearinghouse for CDS transactions would reduce counterparty and systemic risks and increase market transparency and liquidity.¹⁵⁷ The clearinghouse will reduce counterparty risk by becoming the counterparty to every CDS transaction. Rather than a regulating agency

152. OCC Report, *supra* note 150, at 9.

153. See FDIC Report, *supra* note 150, at 4–5; OCC Report, *supra* note 150, at 7.

154. See Sheerer, *supra* note 10, at 181.

155. A naked CDS transaction is one where the protection buyer has no risk exposure to the underlying, reference entity or asset. Therefore, “naked” CDSs are not considered to hedge risk, but rather are mere speculative bets that may actually increase risks within the CDS market.

156. COMMITTEE ON CAPITAL MARKETS REGULATION, THE GLOBAL FINANCIAL CRISIS, A PLAN FOR REGULATORY REFORM (May 2009), available at [http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmktreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf) (last visited Aug. 1, 2009) [hereinafter CCMR Report].

157. See generally *id.* at 38–49. See also COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM 125–30 (Aug. 2008) [hereinafter CRMPG II Report]; United States Department of the Treasury, *Treasury Outlines Framework For Regulatory Reform, Provides New Rules of the Road, Focuses First on Containing Systemic Risk*, March 26, 2009 [hereinafter U.S. Treasury Press Release].

having to track CDS market activity through each entity engaged in the activity, the clearinghouse will monitor and record all CDS transactions.¹⁵⁸ Backlogged transactions would no longer exist, a problem common in the CDS market without an automated clearinghouse.¹⁵⁹ Further, the clearinghouse would require all CDS parties to post collateral and the clearinghouse would actively manage the collateral postings on a daily basis, demanding additional margin calls in response to a devaluation of the reference entity, obligation, or asset.¹⁶⁰

There are currently three United States-based entities working to get a CDS clearinghouse for the market.¹⁶¹ The same initiatives are currently underway in Europe, one in the United Kingdom under the watch of the Financial Services Authority (FSA), and the other in cooperation with the European Central Bank (ECB).¹⁶² These clearinghouses have gained approval in the United States and recently gained approval in the European Union as well.¹⁶³

However beneficial a CDS clearinghouse would be for the financial markets, it does not come without costs and problems of its own. The initiation of a clearinghouse raises a substantial question, should all CDS contracts be forced to go through a clearinghouse? Having all CDSs conducted through a clearinghouse would likely reduce systemic risk and increase the ease for the governmental agency to monitor transactions. However, this massive standardization of CDS contracts may greatly reduce the usage and benefit of a financial product that is highly customized to meet each party's requests.¹⁶⁴ Although clearinghouses are currently transacting with CDS contracts, not all CDSs will be able to trade through a clearinghouse due to their customized design.¹⁶⁵ Essentially, to a certain extent, market participants will decide which CDSs contain enough

158. See CCMR Report, *supra* note 156, at 42.

159. See Tijoe, *supra* note 130, at 408–10. The large amount of unconfirmed CDS trades creates a confirmation backlog. Backlogged transactions raise the risk that the CDS will not be honored upon the occurrence of the credit event. Further, this increases counterparty and systemic risks because an entity or investor cannot be certain which entities hold CDSs.

160. See CCMR Report, *supra* note 156, at 42.

161. See *id.* at 42–43.

162. See *id.* at 44.

163. Neil Shah, *EU Derivatives Revamp Plan Puts Bankers on Edge*, WALL STREET JOURNAL, July 3, 2009, at C2, available at <http://online.wsj.com/article/SB124655644071187209.html> (last visited Aug. 1, 2009).

164. See CCMR Report, *supra* note 156, at 46–47.

165. GOV'T ACCOUNTABILITY OFFICE, SYSTEMIC RISK: REGULATORY OVERSIGHT AND RECENT INITIATIVES TO ADDRESS RISK POSED BY CREDIT DEFAULT SWAPS 22 (Mar. 2009), available at <http://www.gao.gov/new.items/d09397t.pdf> (last visited Aug. 1, 2009).

standardization to be cleared through a clearinghouse. Yet certain standardized, high-volume CDSs will require clearinghouse confirmation, no matter the interests of the parties involved, thus creating a group of exchange-traded CDSs.¹⁶⁶

Not all CDSs can be directed through a clearinghouse; some are so complex and customized that a clearinghouse transaction is highly inefficient and costly. Rather than force these CDSs to a clearinghouse, the parties to the CDS will be required to hold additional capital reserves to adjust for the lack of clearinghouse oversight and collateral requirements to minimize counterparty and systemic risks.¹⁶⁷ Additionally, non-standardized CDS trades will be reported to trade repositories and follow the clearinghouse standards for netting, collateral and margin calls, and settlement practices.¹⁶⁸ Therefore, CDS legislation requires more than a clearinghouse initiative in order to minimize counterparty and systemic risks while easing the regulatory agency's ability to monitor the transactions.

Because CDS transactions span the globe, the number of active CDS clearinghouses and their jurisdiction will dictate regulatory efficiency. Having one or two centralized clearinghouses is more efficient than multiple ones;¹⁶⁹ a global market is more manageable when information is condensed into a small number of entities, making oversight easier. But a small number of global clearinghouses will raise two concerns. First, which governmental agency will oversee these entities? This will require extensive international cooperation. Second, the more centralized the CDS transactions, the greater the systemic risk because a few entities hold all the counterparty and other risks. The regulatory oversight will need to be strict and the clearinghouses' collateral and capital reserves will need to be accurately and intensely pursued and monitored in order for the clearinghouse initiatives to be effective.¹⁷⁰

Once the clearinghouses begin to clear all the CDS transactions, the issue of how to organize and present the trade data arises. The current dilemma is the ambiguous state of the CDS market, particularly regarding actual CDS contract prices, price quotes, trade confirmations, trade

166. See CCMR Report, *supra* note 156, at 50–54.

167. See *id.* at 56.

168. U.S. Treasury Press Release, *supra* note 157.

169. See Darrell Duffie & Haoxiang Zhu, *Does a Central Clearing Counterparty Reduce Counterparty Risk?* 13 (Stan. U. Graduate Sch. of Business, Working Paper No. 2022, July 2009), available at <http://www.stanford.edu/~duffie/DuffieZhu.pdf> (last visited Aug. 1, 2009).

170. See CCMR Report, *supra* note 156, at 47–48.

volumes, and parties to CDSs.¹⁷¹ An information-gathering computer model like the Trade Reporting and Compliance Engine (TRACE)¹⁷² would capture, organize, and distribute consolidated information on these CDS transactions to the public. Market aggregate statistics would provide recaps of real-time CDS activity, including the number of CDS transactions and the total notional amount traded, as well as advances, declines, bid-ask spreads, and 52-week highs and lows.¹⁷³

All this information would supply the much needed price transparency to the CDS market, while potentially decreasing transaction costs.¹⁷⁴ As stated by former Chairman of the SEC, Arthur Levitt, “[i]nformed investors, armed with accurate information, ensure that market prices represent fair values. And fair market prices, in turn, ensure that the markets perform their economic function of efficiently allocating capital resources.”¹⁷⁵ By providing the public with CDS market transparency, investors will make improved investment decisions, thus reducing risks and increasing regulatory dexterity.

For those entities trading in CDSs, the entity will need to register with the regulatory agency and meet eligibility requirements. Further, CDS trading entities will need to meet all the recordkeeping and disclosure requirements, as determined by the regulatory agency.¹⁷⁶

One last and potentially vital role of a clearinghouse is the ease at which CDS contracts could be “netted.” Similar to the ISDA Master Agreement’s “close-out netting” provision, a similar clearinghouse standard would obligate parties holding several outstanding CDSs with one another to calculate one settlement amount by offsetting the total amounts owed to each other.¹⁷⁷ Thus, netting would identify and reduce unnecessary

171. See *id.* at 48.

172. TRACE was established through a merger of the NASD with the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. See Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 34-56145 (July 26, 2007), available at <http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf> (last visited Aug. 1, 2009).

173. CCMR Report, *supra* note 156, at 49. See also U.S. Treasury Press Release, *supra* note 148.

174. CCMR Report, *supra* note 156, at 49.

175. Unterman 2009, *supra* note 147, at 87.

176. U.S. Treasury Press Release, *supra* note 157.

177. FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW—A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 81 (March 2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf (last visited Aug. 2, 2009).

redundancies in CDS gross exposures.¹⁷⁸ By closing out the existing CDS exposures, parties can reduce economic risk exposure while increasing accurate information of an entity's position in CDS contracts because replacement losses are minimalized and merged to form one transaction.¹⁷⁹

The Group of Twenty Finance Ministers and Central Bank Governors (G-20) fully support an international clearinghouse for OTC derivative transactions:

Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.¹⁸⁰

However, critics of CDS clearinghouses claim that these institutions are not as beneficial as regulators and academics may think. CDSs are complex and customized financial products making it difficult to properly assess and value the risks of each party to each contract.¹⁸¹ Sellers of CDSs are likely to have an information advantage over a clearinghouse in assessing the risks associated with the transaction, making a clearinghouse less efficient at assessing the risks. Clearinghouses do not have the resources to check every party's balance sheet for other risks, thus they do not adjust CDS transaction margins for the risks the parties carry from other investments. What this signifies is that margins are roughly the same for each party to a CDS because the margins are based on the specific CDS transaction, not the other risks a party holds in other investments. Sharing risks through a clearinghouse may incentivize parties to undertake more risk elsewhere, making a clearinghouse not as efficient a risk sharer as once thought and promoted.¹⁸²

178. *Id.* at 81–83.

179. *Id.*

180. GROUP OF TWENTY FINANCE MINISTERS AND CENTRAL BANK GOVERNORS (G-20), DECLARATION OF THE SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY 3 (Nov. 15, 2008), available at http://www.g20.org/Documents/g20_summit_declaration.pdf (last visited Aug. 2, 2009).

181. Craig Pirrong, *The Clearinghouse Cure*, REGULATION 48, Vol. 31, No. 4, 44, 48 (Winter 2008–2009).

182. *See id.*

If systemic risk is caused by the interconnectedness of large financial institutions, then a clearinghouse will not solve the systemic risk problem. What a clearinghouse needs to accomplish is to force parties to take smaller amounts of CDSs with smaller values and risks as compared to party-to-party transactions; riskier party's need to post higher margins and engage in fewer CDSs.¹⁸³ To complete this, a clearinghouse must expend resources to accurately appraise a party's risks outside the CDS transaction and adjust the margins appropriately. If the clearinghouse fails to charge higher margins for party's carrying more risk, the clearinghouse increases systemic risk because the clearinghouse is undercapitalized given the risks it holds in comparison to the collateral it holds.¹⁸⁴

Finance professionals, politicians, and academics have shown a strong split of opinions as to the need for banning "naked" CDS transactions.¹⁸⁵ Legislation prohibiting the trading of "naked" CDSs would potentially reduce the \$29 trillion CDS market by almost eighty percent, roughly \$23 trillion.¹⁸⁶ "This would basically kill the single-name CDS market . . . [g]iven the small size of many issuers' bonds outstanding, this would make it practically impossible for the CDS market to exist."¹⁸⁷

"Naked" CDS transactions raise the issue of the protection buyer's incentives under the contract. A protection buyer who does not own the underlying reference asset nor has any connection to the reference entity has an incentive to destroy the value of the reference obligation or entity.¹⁸⁸ For example, say your neighbor is able to purchase a CDS with your home as the underlying reference asset and the credit event is the destruction of your home. The insurance company that sold your neighbor the CDS has a strong incentive to ensure that your house is not destroyed because the insurance company wants to receive premium payments and not pay money out. Your neighbor who purchased the CDS has an incentive to destroy your house as soon as possible because he wants to pay as little as possible

183. *See id.* at 49–50.

184. *See id.* at 51.

185. "Naked" CDS transactions involve a purchaser of the CDS contract who has no risk exposure to the underlying, reference obligation. The reason these "naked" CDS transactions are so controversial is because the purchaser is not directly hedging risk, but rather is merely speculating in the market. Thus, some believe that an entity purchasing a CDS must have a direct risk caused by the change in the underlying, reference obligation's value.

186. Matthew Leising, *U.S. Draft Law Would Ban Most Trading in Credit-Default Swaps*, BLOOMBERG.COM, Jan. 29, 2009, available at http://agonist.org/20090129/u_s_draft_law_would_ban_most_trading_in_credit_default_swaps (last visited Aug. 2, 2009).

187. *Id.* (quoting Tim Backshall, Chief Strategist at Credit Derivatives Research LLC).

188. Partnoy & Skeel, *supra* note 83, at 1035.

in premiums, yet collect on the face value of the CDS contract. Your neighbor will benefit more from the destruction of your house than if you are able avert its destruction.

This illustrates the same situation when a speculator purchases a CDS against the default of a company or devaluation of an asset. Typically, an investor who owns an entity's assets or debt instruments wants the entity to remain financially healthy in order to earn higher returns on the investment.¹⁸⁹ However, CDS purchasers would rather see the entity fail and default in order to collect the face value of the CDS contract because it is more profitable than permitting the entity to remain viable.¹⁹⁰ By not owning or otherwise having an interest in the underlying reference asset, obligation, or entity, the speculator stands to earn a larger profit from the occurrence of a credit event than the nonoccurrence. Therefore, the fear is that speculative CDS holders will do what it can to ensure the downfall of the underlying asset, entity, or obligation.¹⁹¹

The Financial Stability Forum (FSF) has supported the termination of physically settled CDSs.¹⁹² CDS contracts should be standardized to eliminate the need for a purchaser of a CDS to physically deliver obligations of the reference entity following a default or other credit event.¹⁹³ The problem with physically settled CDSs arises because there is currently more credit derivatives issued than the value of underlying reference assets. This is caused by the large amount of speculators buying "naked" CDS contracts.¹⁹⁴ If entities hold a large number of speculative CDSs that are to be physically settled and a credit event develops triggering CDS settlement, a rush will occur to acquire the underlying reference assets to satisfy settlement. This artificially inflates the value of the underlying reference assets.¹⁹⁵

This exact situation occurred when Delphi Corporation (Delphi) went bankrupt. CDS protection sellers demanded physical settlement but not all the counterparties owned the underlying Delphi bonds to complete the settlement transactions. The protection buyers were forced into the market to buy the bonds, unnaturally inflating the bond values because Delphi was

189. See Young, McCord & Crawford, *supra* note 2, at 2.

190. See *id.*

191. See Partnoy & Skeel, *supra* note 83, at 1035.

192. FINANCIAL STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 21 (April 2008), available at http://www.financialstabilityboard.org/publications/r_0804.pdf?noframes=1 (last visited Aug. 2, 2009).

193. *Id.*

194. See Tijoe, *supra* note 130, at 400.

195. See *id.*

currently in bankruptcy. The CDS market pushed the Delphi bond market to new highs causing confusion among parties not privy to the CDSs, and protection buyers had to pay artificially high prices to settle the CDS contracts.¹⁹⁶

Recent years have seen a shift from the historical cost accounting methods toward the mark-to-market accounting in response to a perceived need for more relevant financial information from publicly-traded companies to the public and investors.¹⁹⁷ Mark-to-market accounting assigns a value to a position held in an asset or debt based on the current fair market price for the asset or debt. Therefore, mark-to-market accounting allows for the temporary changes in valuation of an asset, usually on a daily or weekly basis.

The Federal Accounting Standard (FAS) 133, Accounting for Derivative Instruments and Hedging Activities, requires all derivative instruments to be measured at fair value using mark-to-market accounting techniques.¹⁹⁸ Proponents of this method argue that adjusting assets to their fair value on a regular basis informs investors of the risks and values of the company. Furthermore, because market prices are reliable and accessible, objectivity and transparency of a company's financial status is enhanced.¹⁹⁹ However, the CDS market is largely opaque with illiquid prices and unreliable CDS contract values, making the calculation of CDS fair values inaccurate.

Critics of mark-to-market accounting state that it may increase instability in the financial markets. Financial institutions typically hold a large variety of assets and debts that exhibit normal market fluctuations in prices. These assets and debts are the underlying reference obligations for a CDS contract, and the fluctuation in the asset and debt prices cause the CDSs to fluctuate in value.²⁰⁰ During an economic downturn—like the 2007–08 global financial crisis—financial institutions are continually forced to write-down their assets. Firms need to sell their assets to anticipate the suspected drops in asset prices that force these write-downs.

196. See *id.* at 401–02.

197. See CCMR Report, *supra* note 156, at 176. Historical cost accounting records an asset into the company's books at its purchase price. Throughout its life, the asset is reported without adjustments made for inflation or temporary changes in valuation. It may be written down if it becomes impaired or systematically depreciated and a gain can be reported only when the asset is sold or otherwise properly disposed of or terminated.

198. FINANCIAL ACCOUNTING STANDARDS BOARD (FASB), STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES 5 (June 1998).

199. See CCMR Report, *supra* note 156, at 176.

200. See *id.* at 176–77.

These asset sell-offs exacerbate the decline in market prices of CDSs, adding additional illiquidity to an already illiquid market, while simultaneously increasing the probability for credit event occurrences, thus increasing counterparty and systemic risks.²⁰¹

Some believe that mark-to-market accounting should prevail in times of regular economic activity, but when the market takes a downswing, regulators would have businesses switch back to the historical cost accounting method.²⁰² Thus, the regulatory body decides when the market has normalized so mark-to-market accounting would be reinstated until another economic disruption occurs.²⁰³ Others believe that mark-to-market accounting should be abandoned all together in markets that are inactive or illiquid, such as the CDS market.²⁰⁴

Given that mark-to-market accounting remains as is, there are propositions that would make this accounting method more transparent and standardized across all markets. First, create an additional disclosure of all the assumptions and estimates underlying the valuation of assets and debts that the company currently holds.²⁰⁵ This would help alleviate the cloud currently surrounding the CDS market because investors could more fully understand a company's concentration of risks and potential benefits for its credit derivative holdings.²⁰⁶

Second, initiate and enforce an additional accounting disclosure that would present both the market and credit value of a company's asset holdings.²⁰⁷ This additional disclosure arises because "it is very difficult to present a single 'fair' value for an asset, particularly in inactive markets and

201. See Guillaume Plantin, Haresh Sapra & Hyun Song Shin, Fair Value Accounting and Financial Stability 5–10 (July 2008) (unpublished paper, prepared for the Financial Stability Review of the Banque de France), available at http://faculty.chicagobooth.edu/haresh.sapra/docs_OP/Fair%20Value%20Accounting%20and%20Financial%20Stability.pdf (last visited Aug. 2, 2009).

202. See CCMR Report, *supra* note 156, at 177.

203. See *id.*

204. See Mike Leyland, *Fair Value: Fool's Value*, ACCOUNTANCY AGE (Sept. 20, 2007), available at <http://www.accountancyage.com/accountancyage/comment/2199136/fair-value-fool-value> (last visited Aug. 2, 2009).

205. Stephen G. Ryan, Accounting in and for the Subprime Crisis 4–5, 32, 47 (Mar. 2008) (unpublished essay), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1115323 (last visited Aug. 2, 2009). See also Scheerer, *supra* note 10, at 186 (discussing the Basel Committee's and International Organization of Securities Commission's recommendations for increased disclosure standards for banks trading and hedging with credit derivatives).

206. See Ryan, *supra* note 205, at 42–43.

207. See CCMR Report, *supra* note 156, at 183. Market value is the current price at which an asset is trading in an observable exchange market. Credit value is an asset's intrinsic worth, as determined by the cash flow characteristics of the asset and its contractual provisions.

distressed circumstances.”²⁰⁸ This new accounting approach requires financial institutions to disclose the market values and credit values of each asset separately and independently of each other. The first disclosure would reflect strict market value based on observable market inputs only, unadjusted for inactivity or distress. The second disclosure would reflect credit value based on a fundamental appraisal of expected long-term performance established independently of market inputs.²⁰⁹ The disclosure should give investors heightened clarity and choice in determining overall investment risk, thereby reducing information asymmetries and enhancing investor protection.²¹⁰ Lastly, additional disclosures and increased institutional transparency will ease the job of regulators overseeing CDS transactions and enforcing CDS regulations.

On November 15, 2008, the Financial Accounting Standards Board (FASB)²¹¹ implemented a new accounting rule requiring enhanced disclosures about an entity's derivative and hedging use in order to provide additional transparency of financial reporting.²¹² Entities are required to provide disclosures about how and why an entity uses derivative instruments, how derivative instruments are accounted for under FASB Statement No. 133 and its related interpretations, and how derivative instruments affect an entity's financial position, performance, and cash flows.²¹³ By requiring this additional disclosure, investors and regulators will better understand derivative use in terms of the risks involved and how an entity plans to manage with them. Further, by disclosing the fair value of the derivatives and their gains and losses in a table format, a complete picture can be seen as to an entity's position in derivatives before, during, and after the reporting period.²¹⁴

208. *Id.* at 183.

209. *Id.* at 184. See also *IASB Provides Update on Applying Fair Value in Inactive Markets*, (International Accounting Standards Board, London, UK), Oct. 14, 2008, available at http://www.iasb.org/NR/rdonlyres/2F9525FD-4671-439D-B08E-27C18C81C238/0/PR_FairValue102008.pdf (last visited Aug. 2, 2009).

210. CCMR Report, *supra* note 156, at 185.

211. The FASB is a not-for-profit, private organization whose primary mission is to develop, create, and modify the generally accepted accounting principles throughout the United States. The FASB is to act in the public's best interest and sets the accounting standards for all the U.S. public companies.

212. FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 161, DISCLOSURES ABOUT DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES I (Mar. 2008).

213. *Id.*

214. *Id.* at 2.

Currently, there is a raging debate as to which federal agency, if any, has jurisdiction over the CDS market.²¹⁵ To further complicate the matter, state insurance commissions are making arguments that a CDS is so similar to an insurance contract that each state should have the authority to regulate CDS contracts under state insurance laws.²¹⁶ With all these substantial recommendations to be implemented to regulate the CDS market, which regulatory agency should head the reforms and oversight?²¹⁷

One recommendation is to reorganize the current United States overlapping sectoral model of federal regulation by creating two or three independent federal regulatory bodies overseeing the U.S. financial system.²¹⁸ This model would retain the current Federal Reserve Bank (FRB) while establishing one or two additional governmental bodies from the existing regulatory agencies. The newly created United States Financial Services Authority (USFSA) would consist of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission

215. McMahon & Collins, *supra* note 40. CDSs cannot be easily categorized as either a security under the supervision of the SEC or as a future under the supervision of the CFTC. This sets the stage for arguing that CDS regulation should be a participant-based approach, meaning that CDSs would only be regulated by regulating the entities that hold the contracts. Further, this fuels the argument that the United States needs to completely renovate the federal regulatory system by creating one, central financial market regulator.

216. See, e.g., *Update on Regulation of Credit Default Swaps*, Special Bulletin (Stroock & Stroock & Lavan, LLP, New York, NY), Feb. 12, 2009, at 3–4, available at <http://www.stroock.com/SiteFiles/Pub712.pdf> (last visited Aug. 3, 2009). The Missouri Department of Insurance requires all sellers of covered CDSs conducting business within Missouri to obtain a certificate of insurance to transact business. Further, the National Conference of Insurance Legislators is pushing for states to have the ability to regulate CDSs as insurance.

217. Currently, the United States employs more financial regulators and expends a higher percentage of its GDP on financial regulation than any other major nation. Compared to the United Kingdom, the United States employs 38,700 staff to do the same job as the 3,100 in the United Kingdom. Further, the United States spends \$497,984 per billion dollars of GDP, versus the \$276,655 by the United Kingdom. Yet recent events show that the United States' larger staff and greater funding have not resulted in more efficient regulation. See *Committee on Capital Markets Regulation Releases Recommendations for Reorganizing U.S. Regulatory Structure* (CCMR, Cambridge, MA), Jan. 14, 2009, at 1 [hereinafter CCMR Press Release].

218. See CCMR Report, *supra* note 156, at 203–10. The FRB would retain its exclusive control of monetary policy and its lender-of-last-resort function as part of its key role in ensuring financial stability. The USFSA would regulate all other aspects of the financial system, including market structure, permissible activities and safety and soundness for all financial institutions. The investor/consumer protection body would monitor the safety and soundness of regulatory actions; any conflict between the supervisory and investor/consumer protection body should be resolved by the U.S. Treasury Department. *Id.*

(CFTC).²¹⁹ Additionally, an independent investor/consumer protection agency would be either merged into the USFSA or created as an independent agency.²²⁰

Because the United States is the financial market leader and the largest recipient of foreign investment, the United States has a distinct and important place in the world. Financial regulation needs to reflect the breadth and significance of the United States on the world stage. The current fragmented United States regulatory system reduced each federal agency's efficiency and resources because the agencies competed for jurisdiction over different sectors of the market.²²¹ Most nations no longer employ the fragmented, sectoral model used by the United States. For example, Australia and the Netherlands employ a central bank and then two federal regulators, while the United Kingdom and Japan employ one central bank and one federal regulator.²²² An Australian professor recently wrote that "Australia's three peaks of market regulation contrast with the 'alphabet soup' of US derivatives regulation watchdogs"²²³ *The Economist* wrote that "the crisis has exposed the SEC as a cracked piston in a sputtering regulatory engine that dates back to the 1930s."²²⁴ Even the Chairman of the CFTC, Walter Lukken, has called for an "objective-based" regulatory system that would merge federal government agencies to form a new system consisting of three agencies: Systemic Risk Regulator, Market Integrity Regulator, and Investor Protection Regulator.²²⁵

Consolidated financial regulation can achieve four goals:

219. *Id.* at 203. The CCMR could not reach a consensus as to the division of regulatory power as to financial institutions between the FRB and the USFSA. Some believe the FRB should regulate all financial institutions, some believe the USFSA should regulate all financial institutions, while others want a split between the two institutions as to regulating financial institutions and markets. *See* CCMR Report, *supra* note 156, at 206–08.

220. *See id.* at 203.

221. *See* CCMR Press Release, *supra* note 217, at 7. The fragmented U.S. regulatory structure impaired the creation of sound international regulations of the CDS market prior to the recent financial crisis.

222. CCMR Report, *supra* note 156, at 204.

223. Latimer, *supra* note 136, at 9.

224. *Growing Insecurities; The Securities and Exchange Commission*, *ECONOMIST*, January, 17, 2009, at 73, available at http://www.economist.com/finance/displaystory.cfm?story_id=12948655 (last visited Aug. 2, 2009).

225. Walter L. Lukken, Commissioner of the CFTC, Keynote Address Before FIA Futures and Options Expo, Chicago, Illinois 3 (Nov. 11, 2009), available at <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-50.pdf> (last visited Aug. 2, 2009).

- 1) consistent regulations across all sectors of the financial markets;
- 2) attract and retain high quality staff and efficient assignment of personnel where needed;
- 3) reduce the regulatory agency's ability to act in favor of special interests rather than the public as a whole; and
- 4) enhance accountability.²²⁶

Harmonization of the new United States regulatory standards is crucial in the CDS market, which does not have national borders. The United States will need to pressure the international community to adopt similar regulations so that a vast network of domestic regulations can be formed. This network of domestic regulations can be monitored by an international forum that has the authority to enforce the network's regulations.²²⁷ Further, the international forum will need to have ample political and economic resources to monitor shocks in the market and perform crisis response.²²⁸ A crucial task of the international forum is to create regulatory dialogue and promote efficient dispute resolution procedures.²²⁹

A lack of international regulatory cooperation will lead to regulatory arbitrage. If a collection of nations employ strict CDS regulations while other nations remain relaxed or unregulated, CDS transactions will move to these lesser regulated nations. In a highly globalized market where national borders do not exist, like the CDS market, international cooperation and consistency is the only way to effectively regulate a market that spans the globe.

On March 26, 2009, Secretary of the United States Treasury, Timothy Geithner, testified before the House Financial Services Committee. Secretary Geithner discussed the United States Treasury's framework for regulatory reform: addressing systemic risk, protecting consumers and investors, eliminating gaps in the United States regulatory structure, and fostering international coordination.²³⁰ He stated that the lack of transparency in the credit derivatives market, at least in part, lead to regulator's failure to understand CDSs' potential ability to threaten the entire financial system and bring down very large institutions, like AIG.

226. See CCMR Press Release, *supra* note 217, at 8.

227. See CCMR Report, *supra* note 156, at 212–13. The CCMR endorses the establishment of a newly strengthened Financial Stability Board, provided it is flexible and expert enough to harmonize baseline rules for the regulation of international finance while still taking a broad view of all the markets in which modern financial conglomerates participate and interact. *Id.*

228. See *id.* at 212.

229. See *id.*

230. See U.S. Treasury Press Release, *supra* note 157.

Secretary Geithner made a profound statement to the House Financial Services Committee: "Let me be clear: the days when a major insurance company could bet the house on credit default swaps with no one watching and no credible backing to protect the company or taxpayers from losses must end."²³¹

VII. CURRENT PENDING U.S. LEGISLATIVE ACTION FOR THE CDS MARKET

Because of investor fears and lack of confidence coupled with the recent bailouts and bankruptcies of major financial institutions, Congress has been scrambling to determine the cause of this financial crisis in order to create new financial standards and regulations. Not surprisingly, Congress has focused some of its time and lawmaking authority to enact legislation that will begin to regulate the CDS market, given the legislation is approved. While Congress has currently initiated eight bills since the start of 2009 through July 2009 that would directly address the CDS market, not one of these bills is an end all solution to the current problem. Hopefully, the bills are the first action in a line of many to come, in which more meticulous and efficient regulation of the CDS market will prevail.

A. *Derivatives Trading Integrity Act of 2009*

On January 15, 2009, Senator Harkin introduced to the Senate the bill entitled the Derivatives Trading Integrity Act of 2009 (DTIA of 2009).²³² The purpose of the DTIA of 2009 is "[t]o amend the Commodity Exchange Act to ensure that all agreements, contracts, and transactions with respect to commodities are carried out on a regulated exchange, and for other purposes."²³³ The DTIA of 2009 would reverse most of the exemptions in the CEA for OTC derivatives by eliminating the distinction between contracts, agreements, and transactions in the "excluded" and "exempt" commodity market from those transactions that are currently required to be traded on regulated exchanges.²³⁴ Essentially, the DTIA of 2009 would

231. Timothy Geithner, U.S. Secretary of the Treasury, Treasury Secretary Tim Geithner Written Testimony House Financial Services Committee Hearing (Mar. 26, 2009), *available at* <http://www.ustreas.gov/press/releases/tg71.htm> (last visited Aug. 2, 2009).

232. Derivatives Trading Integrity Act of 2009, S. 272, 111th Cong. (2009).

233. *Id.*

234. See S. 272 *supra* note 232, at §§ 2-3; 7 U.S.C.A. §§ 1a(10)-(11), 1a(13)-(14), 1a(33), 2(c)-(e), 2(g)-(i), 6(a), 6(c), 6a, 6g(a), 6i, 7a, 7a-1, 7a-2, 7a-3, 7b, 8(b), 16(e). See also *Senate Bill Would Regulate OTC Derivatives and Credit Default Swaps*, (CCH Financial Crisis News Center, Wolters Kluwer, Alphen aan den Rijn, The Netherlands), Jan. 19, 2009, *available at* <http://www.financialcrisisupdate.com/2009/01/senate-bill-would-regulate-otc-derivatives-and-credit-default-swaps.html> (last visited Aug. 2, 2009).

force all these “excluded” and “exempt” transactions to move onto registered and regulated exchanges, including CDS transactions, so to be monitored by the CFTC.²³⁵ Thus, having all OTC derivatives traded on a registered and monitored exchange, transparency, accountability, and integrity of trading of CDSs, as well as other derivatives, should be greatly increased and strengthened.²³⁶

The DTIA of 2009 addresses the issue of CDS market transparency by forcing many, if not all, CDS transactions to take place on a regulated exchange. CDS market information will then be readily available to investors, the public, and regulatory agencies. Further, regulators can easily monitor all CDS transactions, saving time and other resources while promoting regulatory efficiency. With all the transaction information collected and aggregated on a few exchanges, prices of CDSs will be more accurate, thus reflecting the fair value of a company’s credit risk.

However, the DTIA of 2009 contains some flaws. First, the bill makes no attempt to address the standards that the clearinghouses would need to implement, but rather leaves this decision to be determined at a later date. It is of great importance to set margins, capital reserves, and fees on the exchange, or else the exchange will not reduce risks and operate inefficiently; yet this bill fails to address this issue.

Second, it fails to address the terms and definitions within the CDS contracts; what is a standardized contract versus a customized contract? Forcing all CDSs to trade and clear through a regulated exchange requires a detailed analysis of which terms and definitions in a CDS contract are optimal for the market because all CDS contracts will have to be highly standardized. The bill fails to mention who is responsible for this determination: regulators, market consensus, the exchanges, or individual market participants.

Finally, forcing all CDSs to become standardized and clear through an exchange will greatly hinder the market. The CDS market contains contracts that are highly customized to the parties’ needs. CDSs for hedging tend to contain more customized terms than CDSs for speculation. Thus, requiring all CDS contracts to become standardized could destroy the CDS market as a whole, demolish CDSs for hedging purposes while leaving the speculators only, or force CDS participants to develop a new credit derivative that avoids regulation under the DTIA of 2009. Thus, the

235. See S. 272 *supra* note 232, at §§ 2–3; 7 U.S.C.A. §§ 1a(10)–(11), 1a(13)–(14), 1a(33), 2(c)–(e), 2(g)–(i), 6(a), 6(c), 6a, 6g(a), 6i, 7a, 7a-1, 7a-2, 7a-3, 7b, 8(b), 16(e). See also CCH Financial Crisis News Center, *supra* note 234.

236. See S. 272 *supra* note 232, at §§ 2–3; 7 U.S.C.A. §§ 1a(10)–(11), 1a(13)–(14), 1a(33), 2(c)–(e), 2(g)–(i), 6(a), 6(c), 6a, 6g(a), 6i, 7a, 7a-1, 7a-2, 7a-3, 7b, 8(b), 16(e). See also CCH Financial Crisis News Center, *supra* note 234.

DTIA of 2009 is quite simplistic and inflexible for a CDS market that deals with contracts which require customization. So while the DTIA of 2009 carries benefits for the CDS market, it also carries heavy costs which could potentially desolate this market.

B. Derivatives Markets Transparency and Accountability Act of 2009

Representative Peterson introduced the Derivatives Markets Transparency and Accountability Act of 2009 (DMTA of 2009) to the House of Representatives on February 11, 2009.²³⁷ The DMTA of 2009 plans “[t]o amend the Commodity Exchange Act to bring greater transparency and accountability to commodity markets, and for other purposes.”²³⁸ The DMTA of 2009 takes a broad, yet elaborate approach to regulating the credit derivative market. The first section addressing the CDS market is Section 5 of the bill. Section 5 demands all the exempt and excluded OTC derivatives under the CEA to now meet the CFTC’s reporting, accounting, and recordkeeping requirements for a five-year period.²³⁹ The CFTC gains the authority to gather data on any person’s OTC derivative transactions, including CDS positions, to prevent price manipulation, any other disruption to market integrity, or prevent excessive speculation throughout the marketplace.²⁴⁰

Section 11 of the DMTA of 2009 gives the CFTC authority to determine if the exempt and excluded OTC derivatives under the CEA have the potential to:

(A) disrupt the liquidity or price discovery function on a registered entity; (B) cause a severe market disturbance in the underlying cash or futures market; or (C) prevent or otherwise impair the price of a contract listed for trading on a registered entity from reflecting the forces of supply and demand in any market.²⁴¹

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

238. *Id.*

239. *See id.* § 5.

240. *See* H.R. 977, *supra* note 237, at § 5; 7 U.S.C.A. §§ 2(d)(2), 2(g), 2(h)(2)(A), 2(h)(4)(A), 6g(a), 6i. *See also Credit Derivatives: Recent Regulatory Developments* (Morrison & Foerster LLP, San Francisco, CA), Apr. 20, 2009, at 3, available at http://www.mofo.com/news/updates/files/090420Credit_Derivatives.pdf (last visited Aug. 4, 2009).

241. *See* H.R. 977, *supra* note 237, at § 11; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(2)(A), 2(h)(4)(A), 12a(a)(9). *See also* Morrison & Foerster, *supra* note 240, at 3.

If the CFTC makes one of these determinations to be true, then the CFTC has the power to impose position limits on the relevant transactions, to a level the CFTC deems proper.²⁴² Basically, the authority granted under Section 11 to the CFTC appears to permit the CFTC to limit—and perhaps terminate—any privately-negotiated OTC transaction, including those entered into between otherwise regulated entities, such as banks, broker-dealers, and insurance companies.²⁴³

The DMTA of 2009 promotes and gives the CFTC authority to establish and monitor clearinghouses for OTC derivatives. Section 13 requires the “exempt” and “excluded” OTC derivatives under the CEA be cleared and settled through a CFTC-registered clearinghouse.²⁴⁴ For the exempt and excluded OTC derivatives under the CEA that involve a reference obligation that is a financial instrument (*i.e.* securities and bonds), the DMTA of 2009 gives the SEC the authority to force these transactions to be cleared and settled through a SEC-registered clearinghouse.²⁴⁵ Also, Section 13 explicitly denies the FRB the authority to regulate the clearing and trading of OTC derivatives.²⁴⁶

However, there is one twist in Section 13. If parties to an OTC derivative transaction do not want to clear the transaction through one of the clearinghouses, the parties may request the CFTC to permit no clearinghouse transaction, but the parties must report the transaction and its details directly to the CFTC.²⁴⁷ These CFTC exemptions should be granted for transactions that are highly customized, transacted infrequently, do not serve a significant price discovery function in the marketplace, and are

242. See H.R. 977, *supra* note 237, at § 11; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(2)(A), 2(h)(4)(A), 12a(a)(9). See also Morrison & Foerster, *supra* note 240, at 3.

243. See H.R. 977, *supra* note 237, at § 11; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(2)(A), 2(h)(4)(A), 12a(a)(9). See also Morrison & Foerster, *supra* note 240, at 3.

244. See H.R. 977, *supra* note 237, at § 13; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(1), 2(h)(3), 6, 6(c)(1), 7a-1(b), 7a-1(c)(2), 27e; 12 U.S.C.A. § 4422 (West 2009). See also Morrison & Foerster, *supra* note 240, at 3–4.

245. See H.R. 977, *supra* note 237, at § 13; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(1), 2(h)(3), 6, 6(c)(1), 7a-1(b), 7a-1(c)(2), 27e; 12 U.S.C.A. § 4422 (West 2009). See also Morrison & Foerster, *supra* note 240, at 3–4.

246. See H.R. 977, *supra* note 237, at § 13; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(1), 2(h)(3), 6, 6(c)(1), 7a-1(b), 7a-1(c)(2), 27e; 12 U.S.C.A. § 4422 (West 2009). See also Morrison & Foerster, *supra* note 240, at 3–4.

247. See H.R. 977, *supra* note 237, at § 13; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(1), 2(h)(3), 6, 6(c)(1), 7a-1(b), 7a-1(c)(2), 27e; 12 U.S.C.A. § 4422 (West 2009). See also Morrison & Foerster, *supra* note 240, at 3–4.

entered into by parties that can demonstrate financial stability.²⁴⁸ Further, the parties must demonstrate the same financial integrity required by a clearinghouse and meet similar collateral and margin standards established by a clearinghouse.²⁴⁹ Thus, without the CFTC exemption, the CDS will be transacted through a registered clearinghouse, or not at all.

The last section and potentially the most controversial is Section 16. Section 16 grants the CFTC the power to suspend trading in any CDS if the CFTC believes the suspension of CDS trading is in the public interest or needed to protect investors.²⁵⁰ However, before the CFTC may act in this fashion, the CFTC must receive approval from the President of the United States.²⁵¹ It also contains a definition of a CDS, which, oddly enough, uses the verb “to insure” as if a CDS functions as an insurance contract.²⁵² “The term ‘credit default swap’ means a contract which insures a party to the contract against the risk that an entity may experience a loss of value as a result of an event specified in the contract, such as a default or credit downgrade.”²⁵³

It should be noted that an earlier draft of the DMTA of 2009 would have prohibited any party from entering into a CDS unless the entity had a direct exposure to the underlying reference asset, a “naked” CDS. However, representatives of the ISDA, as well as other organizations, successfully argued for the removal of this limitation, stating that it would effectively turn all CDS contracts into insurance contracts and eliminate the CDS business as we know it.²⁵⁴ Therefore, the DMTA of 2009 was amended to remove this Section 16 prohibition of “naked” CDS transactions.²⁵⁵

248. See H.R. 977, *supra* note 237, at § 13; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(1), 2(h)(3), 6, 6(c)(1), 7a-1(b), 7a-1(c)(2), 27e; 12 U.S.C.A. § 4422 (West 2009). See also Morrison & Foerster, *supra* note 240, at 3–4.

249. See H.R. 977, *supra* note 237, at § 13; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(g), 2(h)(1), 2(h)(3), 6, 6(c)(1), 7a-1(b), 7a-1(c)(2), 27e; 12 U.S.C.A. § 4422 (West 2009). See also Morrison & Foerster, *supra* note 240, at 3–4.

250. H.R. 977, *supra* note 237, at § 16(b). See also Morrison & Foerster, *supra* note 240, at 4.

251. See H.R. 977, *supra* note 237, at § 16; 7 U.S.C.A. §§ 1a, 6c. See also Morrison & Foerster, *supra* note 240, at 4.

252. H.R. 977, *supra* note 237, at § 16(b).

253. *Id.*

254. Orrick Financial Markets Client Alert, *Over-the-Counter Derivatives and the Derivatives Markets and Transparency Accountability Act of 2009*, (Orrick, Herrington & Sutcliffe LLP, San Francisco, CA), Feb. 19, 2009, available at <http://www.orrick.com/fileupload/1643.pdf> (last visited Aug. 2, 2009).

255. See *id.*

The DMTA of 2009 is more robust than the DTIA of 2009. Again, the bill would establish CDS clearinghouses of which would be regulated by the CFTC or SEC, depending on the underlying reference asset. CDS market information will then be readily available to investors, regulatory agencies, and the public. Thus, regulators can easily monitor all CDS transactions, and the transaction information will be collected and aggregated in a few number of registered clearinghouses. Furthermore, the DMTA of 2009 does not require all CDSs to be standardized and cleared through a clearinghouse, which will permit parties to customize CDS contracts to each party's individual needs. However, the non-clearinghouse transacted CDS will need to be recorded with the CFTC and meet the margin and capital reserve requirements set by the clearinghouses. This approach is much more flexible than that under the DTIA of 2009; it reduces the need to set strict, standardized contract terms.

The bill gives the CFTC ample power to set speculative limits on CDS transactions. If the CFTC believes CDS speculation has reached a level that could harm the market, the CFTC may limit CDS transactions, or terminate CDS transactions all together. The bill fails to set strict standards for when the CFTC may act in this capacity; rather leaving the standards open to the CFTC for later determination. This new power given to the CFTC can prove both beneficial and detrimental to the CDS market, depending on the standards that will govern a suspension or termination of CDS trading. Perhaps, the CFTC may be receiving too much unchecked authority to limit and control the CDS market.

The broad reporting requirements will be a small burden on the parties to a CDS because most transactions will be conducted through a clearinghouse. When these diminutive costs are compared to the great benefit that investors and regulators will gain in a market that is currently opaque, reporting CDS transaction data is the simplest form of oversight. Large disclosure of CDS transaction information to regulators and investors will reduce market manipulation, increase price accuracy, and give the market the confidence it currently lacks. However, it is difficult to argue that the CFTC's new authority is more injurious to the CDS market than the current situation of having no authority in this marketplace.

C. Financial System Stabilization and Reform Act of 2009

Representative Castle introduced the Financial System Stabilization and Reform Act of 2009 (FSSRA of 2009) on March 26, 2009 in the House of Representatives.²⁵⁶ FFSRA of 2009 intends "[t]o create a systemic risk monitor for the financial system of the United States, to oversee financial

256. Financial System Stabilization and Reform Act of 2009, H.R. 1754, 111th Cong. (2009).

regulatory activities of the Federal Government, and for other purposes.”²⁵⁷ Section 118 begins by including a definition of a CDS:

A bilateral derivative contract that transfers, in exchange for 1 or more lump-sum or other payments, from 1 party to another, the risk that an entity, regardless of whether owned by the buyer of the protection, may experience a loss of value from a credit event such as a default, credit downgrade, or other contractually agreed-upon adverse event.²⁵⁸

Further, Section 118 defines a credit default swap trading clearinghouse as “an approved centralized clearinghouse for credit-default swap trading that is designated by the Securities and Exchange Commission, in consultation with the Commodity Futures Trading Commission and the Chairman of the Board of Governors of the Federal Reserve System.”²⁵⁹ However, the CFTC has the lone authority to oversee the activities of the clearinghouse. This CDS clearinghouse will need to be adequately capitalized by CDS market participants, and the clearinghouse may charge CDS parties a fee to create a default fund and impose trading limits.²⁶⁰

Also, Section 118 demands the CFTC to require any person holding, maintaining, or controlling any position in a CDS traded through the clearinghouse to keep records of the transactions for at least five years.²⁶¹ Therefore, the CFTC must establish rules for continuous reporting of these CDS positions.²⁶²

In Section 120 of the FSSRA of 2009, any person that engages in a CDS must utilize one of the designated clearinghouses to clear the transaction.²⁶³ Section 120 does not require any other action under the CDS to take place through the clearinghouse, such as the settlement of the contract.²⁶⁴ Further, the SEC has the authority to issue rules for the

257. *Id.*

258. *Id.* at § 118.

259. *Id.*

260. See H.R. 1754, *supra* note 256, at § 118; 7 U.S.C.A. §§ 2(h), 6a(e). See also Morrison & Foerster, *supra* note 240, at 4.

261. See H.R. 1754, *supra* note 256, at § 118; 7 U.S.C.A. §§ 2(h), 6a(e). See also Morrison & Foerster, *supra* note 240, at 4.

262. See H.R. 1754, *supra* note 256, at § 118; 7 U.S.C.A. §§ 2(h), 6a(e). See also Morrison & Foerster, *supra* note 240, at 4.

263. H.R. 1754, *supra* note 256, at § 120. See also Morrison & Foerster, *supra* note 240, at 4.

264. H.R. 1754, *supra* note 256, at § 120. See also Morrison & Foerster, *supra* note 240, at 4.

clearance of a CDS and to enforce anti-fraud and anti-manipulation laws regarding any and all CDS transactions.²⁶⁵

The largest provision of the FSSRA of 2009 would create the Financial Stability Council (FSC). The FSC will serve independently from the current federal regulatory structure as a systemic risk monitor.²⁶⁶ Therefore, the FSC would receive the power and authority to prevent and mitigate the systemic risks throughout the financial system.²⁶⁷ With this power, the FSC can propose changes to regulatory policy, close regulatory gaps, impose penalties, and impose rules onto financial institutions regulating capital requirements, risk premiums, and long-term debt conditions.²⁶⁸ Because CDSs are used and traded among large financial institutions, this bill will permit direct and indirect regulation of all CDS transactions by use of regulated clearinghouses and the FSC.

This bill poses a similar problem as the exchange requirements under the DTIA of 2009. Demanding that a CDS be cleared through a clearinghouse will require a high level of standardization of CDS contracts. In order for a clearinghouse to set margins, capital reserves, and fee standards, the cleared CDS contracts will require highly standardized terms, a counterproductive method to the current CDS market. The more standardized are these CDS contracts, the less beneficial the CDSs will be to the parties because a CDS for hedging purposes is designed to be customized for each individual transaction. So the dilemma remains as to the level of standardization necessary to make clearinghouses efficient and beneficial, but not destroy the value that a CDS can serve for a financial institution looking to hedge credit risks.

Also, only requiring a CDS transaction to be cleared through the clearinghouse and nothing more could place gaps in CDS information because parties can sell, trade, transfer, or novate a CDS after the initial transaction without reporting this secondary transaction to the regulator, unless the CFTC sets strict reporting standards. This means that either party may decide that they no longer want to hold the risks derived from the transaction, so they transfer the CDS to another party. Without the secondary transaction having to go through a clearinghouse, CDSs may return to an obscure market that existed prior to the legislation. This bill may partially reduce this dilemma because any person holding, maintaining, or controlling a CDS will need to keep records of it for five years. If this statement translates to all secondary transactions will require confirmation

265. H.R. 1754, *supra* note 256, at § 120. See also Morrison & Foerster, *supra* note 240, at 4.

266. H.R. 1754, *supra* note 256, at § 111.

267. *Id.* §§ 112–13.

268. *Id.*

through a clearinghouse, then all transactions will be recorded and monitored. If it translates to only the original transaction will require confirmation through a clearinghouse, then information regarding secondary transactions will only surface when regulators examine an entity's CDS records. The CFTC will need to address and create aggressive reporting standards to ensure the constant reporting of CDS transactions.

D. Authorizing the Regulation of Swaps Act of 2009

The Authorizing the Regulation of Swaps Act of 2009 (ARSA of 2009) was introduced into the Senate on March 26, 2009 by Senators Levin and Collins.²⁶⁹ This bill has a straightforward purpose, "[t]o authorize the regulation of credit default swaps and other swap agreements, and for other purposes."²⁷⁰ The ARSA of 2009, if passed as law, would free multiple federal regulators to regulate swap agreements, like CDSs, without mandating how that regulatory authority is to be exercised. Because the ARSA of 2009 aspires to create regulations for CDS transactions, the bill eliminates several sections from previous federal statutes.

First, it deletes Sections 206A, 206B, and 206C of the Gramm-Leach-Bliley Act (GLB Act).²⁷¹ This invalidates the current definitions of "swap agreement," "security-based swap agreement," and "non-security-based swap agreement."²⁷²

Next, it deletes Section 2A of the Act of 1933 and Section 3A of the Act of 1934.²⁷³ This invalidates the certainty that swaps are not securities under these Acts. However, swaps may or may not be considered securities under these two Acts, there is no clear guidance set by this bill.²⁷⁴

269. The Authorizing the Regulation of Swaps Act, S. 961, 111th Cong. (2009).

270. *Id.* at § 2.

271. See S. 961, *supra* note 269, at § 2; H.R. 5660, *supra* note 101, at § 301; 15 U.S.C.A. § 78c note. See also *The Authorizing the Regulation of Swaps Act*, (Davis Polk & Wardwell LLP, New York, NY), May 13, 2009, at 3, available at <http://www.davispolk.com/1485409/clientmemos/2009/05.13.09.Levin.Collins.Bill.pdf> (last visited Aug. 4, 2009).

272. See S. 961, *supra* note 269, at § 2; H.R. 5660, *supra* note 101, at § 301; 15 U.S.C.A. § 78c note. See also Davis Polk & Wardwell, *supra* note 271, at 3.

273. See S. 961, *supra* note 269, at § 2; 15 U.S.C.A. §§ 77b-1, 78c-1. See also Davis Polk & Wardwell, *supra* note 271, at 2.

274. See S. 961, *supra* note 269, at § 2; 15 U.S.C.A. §§ 77b-1, 78c-1. See also Davis Polk & Wardwell, *supra* note 271, at 2.

Further, it erases Sections 403, 404, and 407 of the Legal Certainty for Bank Products Act.²⁷⁵ This abrogates the exemption of swaps from the CEA and certain other recognized financial products used by banks.²⁷⁶ Thus, CDSs entered into by banking institutions are no longer exempted from federal regulation, with the CFTC now receiving authority to regulate CDSs where at least one party is considered to be a banking institution.

Additionally, it cancels Section 2(d) of the CEA.²⁷⁷ This dissolves the exclusion of swaps from most of the CEA provisions as agreements, contracts, or transactions in “excluded commodities.”²⁷⁸ Thereafter, it deletes Section 2(g) of the CEA.²⁷⁹ This invalidates the exclusion of swaps from most of the CEA provisions as agreements, contracts, or transactions in “commodities other than agricultural commodities.”²⁸⁰ Finally, it erases Sections 2(h)(1) and 2(h)(2) of the CEA.²⁸¹ This abrogates the exclusion of swaps from most of the CEA provisions as agreements, contracts, or transactions in “exempt commodities” as defined in Section 1a(14) of the CEA.²⁸²

Furthermore, it cancels Section 5(d) of the CEA.²⁸³ This dissolves the ability to trade on an “exempt board of trade.”²⁸⁴ To be an exempt board of trade, an entity needs to limit trading on or through the facilities of the board of trade to commodity contracts for sale for future delivery in which the commodities have a nearly inexhaustible deliverable supply, a large enough deliverable supply and liquid enough cash market to defeat fears of

275. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 27a–b, 27e. See also Davis Polk & Wardwell, *supra* note 271, at 2.

276. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 27a–b, 27e. See also Davis Polk & Wardwell, *supra* note 271, at 2.

277. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 2(d), 2(g), 2(h)(1)–(2). See also Davis Polk & Wardwell, *supra* note 271, at 3.

278. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 2(d), 2(g), 2(h)(1)–(2). See also Davis Polk & Wardwell, *supra* note 271, at 3.

279. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 2(d), 2(g), 2(h)(1)–(2). See also Davis Polk & Wardwell, *supra* note 271, at 3.

280. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 2(d), 2(g), 2(h)(1)–(2). See also Davis Polk & Wardwell, *supra* note 271, at 3.

281. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 2(d), 2(g), 2(h)(1)–(2). See also Davis Polk & Wardwell, *supra* note 271, at 3.

282. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. §§ 2(d), 2(g), 2(h)(1)–(2). See also Davis Polk & Wardwell, *supra* note 271, at 3.

283. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. § 7a-3. See also Davis Polk & Wardwell, *supra* note 271, at 3.

284. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. § 7a-3. See also Davis Polk & Wardwell, *supra* note 271, at 3.

manipulation, and no cash market and on which exchange only eligible contract persons enter into contracts.²⁸⁵ A CDS transaction met the “exempt board of trade” definition because credit risk has a nearly unlimited supply, the CDS market contains a significant number of contracts and monetary value to create a large deliverable supply of contracts to defeat manipulation fears, and CDSs have no cash market and exchange where these CDS transactions occur.²⁸⁶

Lastly, Section 2 of the ARSA of 2009 deletes sections 301(b) and 304 of the CFMA.²⁸⁷ This provision eliminates the application of the Act of 1933’s and Act of 1934’s definition of “security” within the CFMA.²⁸⁸ Also, it discards the savings provisions of the CFMA, which stated that the CFMA would and could not be construed as finding or implying that a swap agreement is or is not a security, futures contract, or commodity under current federal laws.²⁸⁹

Section 3 of the ARSA of 2009 authorizes a:

Federal financial regulator [to] exercise oversight over (A) any swap agreement that is entered into, purchased or sold by any institution, entity or person . . . that is subject to the jurisdiction of the Federal financial regulator; and (B) any swap agreement that is subject to the jurisdiction of the Federal financial regulator.²⁹⁰

Furthermore, the “federal financial regulator” can “promulgate, interpret, and enforce regulations, issue orders of general applicability, and impose disclosure, reporting, or recordkeeping requirements, procedures, or standards, relating to any swap agreement.”²⁹¹

Also, Section 3 provides the SEC absolute power to regulate swaps traded on or cleared through exchanges or clearinghouses and the CFTC plenary power to regulate swaps executed on, traded on, or cleared through

285. See S. 961, *supra* note 269, at § 2; 7 U.S.C.A. § 7a-3. See also Davis Polk & Wardwell, *supra* note 271, at 3.

286. S. 961, *supra* note 269, at § 2. It should be noted that section 2 of the ARSA of 2009 eliminates other sections from current federal laws; however, an analysis of these other invalidations is not crucial for this Note’s analysis of the CDS market.

287. See S. 961, *supra* note 269, at § 2; H.R. 5660, *supra* note 101, at §§ 301(b), 304.

288. See S. 961, *supra* note 269, at § 2; H.R. 5660, *supra* note 101, at § 301(b); 15 U.S.C.A. §§ 77b(a)(1), 78c(a)(10).

289. See S. 961, *supra* note 269, at § 2; H.R. 5660, *supra* note 101, at § 304.

290. S. 961, *supra* note 269, at § 3.

291. S. 961, *supra* note 269, at § 3. See also Davis Polk & Wardwell, *supra* note 271, at 3–4.

trading facilities or registered entities.²⁹² The ARSA of 2009 clarifies that it does not remove any authority previously provided to federal agencies to regulate swaps.²⁹³

Lastly, the ARSA of 2009 seems to give many regulators authority to regulate swap agreements, but it does not require any to exert such power.²⁹⁴ Rather, it requires a “federal financial regulator” to “consult, work, and cooperate with other Federal financial regulators to promote consistency in the treatment of swap agreements.”²⁹⁵

Compared to the three aforementioned pending congressional bills, the ARSA of 2009 is the most expansive and complex. While the others attempted to establish law with minimal modification to prior laws, this bill heavily alters current federal statutes. The bill utilizes open-ended definitions, possibly to ensure that nothing obstructs CDS regulation while establishing a building block for later regulation. For example, the definition of a “federal financial regulator” includes “any other Federal agency that is authorized under any provision of Federal law to regulate any financial institution or type or class of financial instrument or offering thereof.”²⁹⁶ The expansive nature of the bill will make it adaptable for unforeseen changes in financial markets, but may also include other agencies not intended to have jurisdiction over CDSs.²⁹⁷ Disputes between regulators may increase in frequency, thus utilizing resources on agency conflicts rather than regulating the marketplace.²⁹⁸

This broad drafting creates ambiguity as to which federal agency controls over the CDS market. The bill appears to separate the duties of the SEC and the CFTC. It gives exclusive oversight and regulatory authority to the SEC for securities exchanges and the CDSs traded or cleared within these clearinghouses.²⁹⁹ The CFTC will have authority over commodity trading facilities or registered entities and all CDSs traded or cleared within. However, then the bill provides that it may not limit or reduce the authority

292. See S. 961, *supra* note 269, at § 3; 7 U.S.C.A. § 1a; 15 U.S.C.A. § 78c(a). See also Davis Polk & Wardwell, *supra* note 271, at 4.

293. S. 961, *supra* note 269, at § 3.

294. See S. 961, *supra* note 269, at § 3; 7 U.S.C.A. §§ 2(h)(3), 6(c); 15 U.S.C.A. § 78c(a). See also Davis Polk & Wardwell, *supra* note 271, at 4.

295. See S. 961, *supra* note 269, at § 3; 7 U.S.C.A. §§ 2(h)(3), 6(c); 15 U.S.C.A. § 78c(a). See also Davis Polk & Wardwell, *supra* note 271, at 4.

296. S. 961, *supra* note 269, at § 4.

297. See Davis Polk & Wardwell, *supra* note 271, at 5.

298. See *id.* at 4–5.

299. S. 961, *supra* note 269, at § 4. See also Davis Polk & Wardwell, *supra* note 271, at 5–6.

of a "federal financial regulator" with respect to swaps.³⁰⁰ Thus, the bill blurs the line as to which federal agency will regulate which entities and which type of CDS contracts.³⁰¹

One major contradictory definition in the bill is the use of the term "swap agreement." Under the bill, a "swap agreement" must be subject to individual negotiation and entered into between eligible contract participants. The SEC has expressed the definition that standardized, centrally cleared swaps are not "individually negotiated."³⁰² Therefore, swaps that are cleared and trade through an exchange or clearinghouse would cease to fit within the SEC's definition of "swap agreement," limiting the SEC's authority to regulate certain CDS contracts.³⁰³ These inconsistencies, among others, within this draft will demand future legislation to clarify the ambiguities or federal regulators will be forced to work out the details as the situation arises, which will likely be made in haste as a quick fix.³⁰⁴

The ARSA of 2009 incorporates an almost identical definition of a "swap agreement" as used in the CFMA; which is a very broad definition.³⁰⁵ This broad definition will include many types of financial instruments, with the "federal financial regulators" having authority over these "swap agreements."³⁰⁶ Therefore, the federal financial regulators will have to decide which agency will regulate which financial instrument, while simultaneously bringing other transactions not currently under federal regulation into the realm of federal regulation, such as insurance contracts.

E. Prevent Unfair Manipulation of Prices Act of 2009

Representative Stupak introduced the Prevent Unfair Manipulation of Prices Act of 2009 (PUMP of 2009) to the House of Representatives on May 14, 2009.³⁰⁷ The PUMP of 2009 plans "[t]o provide for regulation of futures transactions involving energy commodities, to regulate credit default swaps . . . and for other purposes."³⁰⁸ While this bill focuses on

300. S. 961, *supra* note 269, at § 4. See also Davis Polk & Wardwell, *supra* note 271, at 5–6.

301. S. 961, *supra* note 269, at § 4. See also Davis Polk & Wardwell, *supra* note 271, at 5–6.

302. See Davis Polk & Wardwell, *supra* note 271, at 7.

303. See *id.*

304. See *id.* at 6–7.

305. See S. 961, *supra* note 269, at § 4.

306. See Davis Polk & Wardwell, *supra* note 271, at 7.

307. Prevent Unfair Manipulation of Prices Act of 2009, H.R. 2448, 111th Cong. (2009).

308. *Id.*

regulating the energy derivatives market, it possesses consequences for the CDS market as well.

Section 6 of the PUMP of 2009 would require all derivatives to be traded and cleared through a registered clearing organization, including CDSs, by eliminating many of the current exemptions and exclusions for OTC derivatives.³⁰⁹ However, the CFTC may waive the need for a CDS transaction to be cleared through a registered clearing organization under certain conditions.³¹⁰ Before the CFTC may grant the clearinghouse exemption, the CFTC must consult the primary regulator of the underlying reference asset.³¹¹ The CDS transaction must be highly customized as to the material nature of the contract's terms, transacted infrequently, not serve a significant price-discovery function in the market, and the parties can show financial integrity as determined by the CFTC.³¹² Further, the transaction must be reported directly to the CFTC in a manner determined by the CFTC.³¹³ Lastly, the CFTC, SEC, and FRB will enter into a written memorandum that discusses the details of this exemption.³¹⁴

Section 7 makes it unlawful for anyone to trade in "naked" CDSs.³¹⁵ The PUMP of 2009 states that:

It shall be unlawful for any person to enter into a credit default swap unless the person (1) owns a credit instrument which is insured by the credit default swap; (2) would experience financial loss if an event that is the subject of the credit default swap occurs with respect to the credit instrument; and (3) meets such capital adequacy standards³¹⁶

Thus, at least one of the CDS participants must stand to experience a financial loss regarding the underlying reference asset in the occurrence of

309. See H.R. 2448, *supra* note 307, at § 6; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(h)(1), 2(h)(3), 2(g), 6, 6(c)(1), 7a-1(c)(2).

310. See H.R. 2448, *supra* note 307, at § 6; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(h)(1), 2(h)(3), 2(g), 6, 6(c)(1), 7a-1(c)(2).

311. See H.R. 2448, *supra* note 307, at § 6; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(h)(1), 2(h)(3), 2(g), 6, 6(c)(1), 7a-1(c)(2).

312. See H.R. 2448, *supra* note 307, at § 6; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(h)(1), 2(h)(3), 2(g), 6, 6(c)(1), 7a-1(c)(2).

313. See H.R. 2448, *supra* note 307, at § 6; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(h)(1), 2(h)(3), 2(g), 6, 6(c)(1), 7a-1(c)(2).

314. See H.R. 2448, *supra* note 307, at § 6; 7 U.S.C.A. §§ 2(d)(1)–(2), 2(h)(1), 2(h)(3), 2(g), 6, 6(c)(1), 7a-1(c)(2).

315. See H.R. 2448, *supra* note 307, at § 7; 7 U.S.C.A. § 6c.

316. See H.R. 2448, *supra* note 307, at § 7; 7 U.S.C.A. § 6c.

the credit event.³¹⁷ Also, the CFTC has the authority to set and enforce capital reserve requirements for all entities engaged in the CDS market.³¹⁸

This bill strikes a balance between forcing all CDSs to be cleared and traded through a clearinghouse while permitting certain CDS contracts, the ones that meet the aforementioned requirements, to remain outside the clearinghouse. The CDS market is given the freedom to choose between two options: either trade CDS contracts that are standardized by use of a clearinghouse, or trade CDS contracts that are customized by use of the OTC market but directly report the transaction information directly to the CFTC.³¹⁹ Given that the CFTC, SEC, and FRB create efficient and effective regulations for monitoring and reporting CDS transaction information, the PUMP of 2009 may prove highly beneficial to the marketplace.

However, the one great pitfall within this bill is its complete prohibition of “naked” CDS contracts. Outlawing all “naked” transactions will greatly reduce the liquidity and price accuracy within the market. The fewer transactions a market contains, the less liquid the instruments and the more likely the prices of these instruments do not accurately reflect the true price of risk. Because a majority of CDS transactions are “naked,” and thus speculative, an absolute banning of these transactions will greatly reduce the size of the market; which could potentially cause the entire market to cease. Thus, a prohibition of all “naked” CDSs is probably not the most efficient answer, but rather placing certain limitations on this type of transaction may better suit market efficiency and investor protection.

F. Credit Default Swap Prohibition Act of 2009

The Credit Default Swap Prohibition Act of 2009 (CDSP of 2009) was introduced into the House of Representatives on July 9, 2009 by Representative Waters.³²⁰ This bill’s stated purpose is “[t]o amend the securities laws to prohibit credit default swaps and to provide the Securities

317. See H.R. 2448, *supra* note 307, at § 7; 7 U.S.C.A. § 6c.

318. See H.R. 2448, *supra* note 307, at § 7; 7 U.S.C.A. § 6c. Section 7 also eliminates the preemption of state bucketing laws regarding “naked” CDS transactions. This would permit state and local governments to regulate or prohibit a brokerage enterprise from taking the opposite side of a “naked” CDS transaction without the brokerage firm executing or reporting the transaction to a regulated exchange.

319. The PUMP of 2009 permits CDS transactions to avoid the clearing requirement and be classified as an exempt transaction if these transactions are highly customized as to the material terms and conditions, are transacted frequently, and do not serve a significant price-discovery function in the marketplace. See H.R. 2448, *supra* note 307, at § 6(b). If the CDS transactions do not meet these three requirements, then the transactions are to be cleared through a clearinghouse.

320. Credit Default Swap Prohibition Act of 2009, H.R. 3145, 111th Cong. (2009).

and Exchange Commission with the authority to regulate swap agreements.”³²¹ The CDSP of 2009, if passed, would completely prohibit the trading in all CDSs.³²² The bill alters the definition of a CDS under the Act of 1933 and 1934 by defining a CDS as:

(A) a swap agreement (as such term is defined in section 206A of the Gramm-Leach-Bliley Act) that protects a party to such agreement against the risk of a loss of value because of the occurrence or non-occurrence of an event or contingency specified in such agreement relating to a security, loan, or other reference asset; and (B) such other forms of credit risk protection as the Commission may, by rule, prescribe as necessary or appropriate in the public interest or for the protection of investors.³²³

Representative Waters plans for this definition to encompass all forms and variations of CDS contracts, so that the bill is able to prohibit all trading in the CDS market. Thus, to eliminate trading in CDS contracts, the CDSP of 2009 amends the Act of 1934 by making it “unlawful for any person to enter into a credit default swap agreement or contract.”³²⁴

Under this bill, the definition of a CDS may stand to not completely eliminate all CDS trading as planned. First, the bill prohibits CDSs which solely reference securities, loans, and other assets as the underlying reference asset, not the CDSs that reference anything outside the definition of an asset. So while this definition will likely eliminate the majority of current CDS trading, parties will continue to trade in CDSs not referencing assets, or rather find other means by which a CDS may indirectly reference an asset. However, the bill gives the CFTC the authority to determine if other forms of credit protection will be considered a CDS contract. So if the CFTC decides to place these other forms of credit protection under the jurisdiction of the CDSP of 2009, they would meet the definition of a CDS and their trading would be prohibited.

Secondly, the definition is vague as to how the party must suffer the “loss of value.” If the transaction is a “naked” CDS, neither party has a risk of “loss of value” regarding the underlying reference asset because neither party owns the underlying reference asset. Therefore, if the “loss of value”

321. *Id.*

322. *Id.* § 4. The CDSP of 2009 also gives the SEC the authority to regulate other swap agreements, notwithstanding the limitation placed on CDSs; however, because this analysis is outside the realm of CDSs, it is not necessary for this Note. *See id.* § 3.

323. H.R. 3145, *supra* note 320, at § 3; 15 U.S.C.A. §§ 77b(a), 78c(a).

324. *See* H.R. 3145, *supra* note 320, at § 4; 15 U.S.C.A. § 78g.

definition in the CDSP of 2009 refers to the underlying reference asset, than a “naked” CDS transaction is not restricted by this bill. If the transaction is a CDS used for hedging, one party has the risk of “loss of value” regarding the underlying reference asset because at least one party owns the underlying reference asset. Therefore, the party owning the underlying reference asset bears to suffer a “loss of value” given the credit event occurs, so the CDSs for hedging will be banned under the bill. Because the purpose of the bill is to prohibit all CDSs, the “loss of value” should refer to the value of the party’s position in the CDS contract. Therefore, at least one party to the CDS stands to endure a “loss of value” because the parties are in opposing positions; one party’s gain is the other party’s loss.

G. Transparent Markets Act of 2009

On July 9, 2009, Representative Larson introduced to the House of Representatives the bill entitled the Transparent Markets Act of 2009 (TMA of 2009).³²⁵ The purpose of the TMA of 2009 is “[t]o amend the Internal Revenue Code of 1986 to impose a tax on over-the-counter derivatives transactions, and for other purposes.”³²⁶ The bill would permit the U.S. Treasury Department to impose a tax on all covered derivative transactions. The amount of this tax is 0.25% of the fair market value of the underlying reference asset with respect to the derivative involved in the transaction.³²⁷ Further, all the parties to the transaction will be held jointly and severally liable for the imposed tax.³²⁸ The bill explicitly lists transactions which would be subject to the tax, in which CDSs are one of these transactions to be taxed.³²⁹

The term “covered derivative transaction,” as used in this bill, refers to any party to a derivative which is not traded on a qualified board or trade, as defined by the Internal Revenue Code.³³⁰ The Internal Revenue Code defines the “qualified board or trade” as a national securities exchange registered with the SEC, a domestic board of trade designated by the CFTC as a contract market, or any other exchange, board of trade, or other market which the U.S. Secretary of the Treasury determines as adequate for the purposes of this definition.³³¹ Therefore, if the CDS contract does not meet

325. Transparent Markets Act of 2009, H.R. 3153, 111th Cong. (2009).

326. *Id.*

327. H.R. 3153, *supra* note 325, at § 2.

328. *Id.*

329. *Id.*

330. *Id.*

331. *See* 26 U.S.C.A. § 1256(g)(7) (West 2009).

the definition of a covered derivative transaction, then the tax will be avoided by the transacting parties.

For this bill to impose the stipulated tax upon CDS transactions, Congress cannot pass legislation forcing all CDSs to be traded through a clearinghouse, or the like. The CDSs which transact through a qualified board or trade (*i.e.* a registered clearinghouse) would avoid the tax imposed by the TMA of 2009. Thus, if Congress passes a law which forces all CDS transaction onto a registered clearinghouse, no CDS will fall under the bill's definition of a covered derivative transaction, avoiding this federal taxation.

While the bill fails to provide for any regulatory authority by a federal agency over the CDS market, the bill will likely cause a decrease in CDS transactions because of the tax. The CDS transaction tax will increase the cost of each CDS and decrease the benefit of each CDS to the parties. Therefore, the tax will likely reduce the total number of CDSs traded in the marketplace. However beneficial this may actually be to the financial markets, if at all, the largest problem with the CDS market is its opaqueness, not the lack of taxation. This bill fails to address the most prevalent concern of the CDS market, regulatory authority and oversight regarding the transactions.

H. Derivatives Trading Accountability and Disclosure Act of 2009

Representative McMahon introduced the Derivatives Trading Accountability and Disclosure Act of 2009 (DTADA of 2009) to the House of Representatives on July 22, 2009.³³² The DTADA of 2009 plans "[t]o provide increased transparency and regulatory requirements for the trading of certain derivative financial instruments."³³³ The bill states that the lack of CDS regulation and the problems with effectively identifying the value and risks of CDSs led to the near collapse of AIG in 2008.³³⁴

Section 3 of the DTADA of 2009 creates a new office within the U.S. Treasury Department, the Office of Derivatives Supervision (ODS).³³⁵ The ODS will oversee the registration of all derivatives traders and will assist in coordinating the SEC's and the CFTC's activities in developing regulations for the buying and selling of derivative instruments.³³⁶ The ODS will assimilate substantive regulations for economically equivalent instruments

332. Derivatives Trading Accountability and Disclosure Act of 2009, H.R. 3300, 111th Cong. (2009).

333. *Id.*

334. *Id.* § 1(b)(6).

335. H.R. 3300, *supra* note 332, at § 3(a).

336. *Id.* at § 3(b)(1)–(2).

and require the development of consistent procedures for reviewing and approving proposals for new products and rulemakings by self-regulatory organizations.³³⁷ Further, the ODS will have the authority to disapprove any regulation set by the SEC or CFTC within thirty days of the recommendation for such new regulation.³³⁸

Furthermore in Section 3, the ODS will be required to prepare and report to Congress regarding all the laws enacted under this bill, an evaluation of the numbers, percentage, volume, and exposure of derivative instruments that are traded on exchanges, cleared through any clearinghouse, or traded in the OTC market, and an assessment of changes to other laws related to the derivatives market.³³⁹

Section 4 requires that all derivative traders must register with the ODS.³⁴⁰ Also, the Secretary of the Treasury, acting through the ODS and after consulting the CFTC and SEC, may exempt a derivatives trader from needing to register with the ODS, or the ODS may temporary suspend a trader's registration.³⁴¹ The Secretary of the Treasury has the discretion to determine if a derivatives trader shall be granted or denied such registration necessary to trade in the market.³⁴²

Also included in Section 4, the Secretary of the Treasury "shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any derivatives trader" if the Secretary of the Treasury finds it to be in the public's interest, given certain conditions are met as listed in this bill.³⁴³ Until the determination of whether a permanent revocation of a derivative trader's registration is proper, the Secretary of the Treasury may temporary suspend the registration until a final decision is made, if the temporary suspension is in the interests of the public and investors.³⁴⁴

Section 5 outlines the rulemaking authority regarding the derivatives market.³⁴⁵ The SEC and the CFTC will have the authority to issue regulations regarding disclosure and transparency requirements, including an audit trail of the record of trading, anti-fraud and truth-in-marketing requirements, mandatory minimum initial margin requirements, mandatory

337. *Id.* § 3(b)(2).

338. *Id.* § 3(b)(4)(A).

339. *Id.* § 3(c).

340. H.R. 3300, *supra* note 332, at § 4.

341. *Id.*

342. *Id.*

343. *Id.*

344. *Id.*

345. H.R. 3300, *supra* note 332, at § 5.

minimum variation margin requirements, and acceptable or permissible types of collateral.³⁴⁶

Requirements placed on the derivatives market by the SEC and the CFTC will be based on the potential systemic risk posed by the derivative transaction and the extent to which the derivative instrument is customized.³⁴⁷ Customization of the instrument requires an analysis of the volume of transactions involving the instrument, the similarity of terms between the instrument and other instruments that are more standardized in the industry, whether the differences between the terms of the instrument and standardized instruments are of an economic significance, and the extent to which the terms are distributed to third parties.³⁴⁸

The SEC and the CFTC, in coordination with the ODS, will determine which derivatives will be traded on an exchange, which will be traded through a clearinghouse, and which derivatives will be traded on the OTC market.³⁴⁹ The bill states that all standardized derivatives shall be permitted to be traded on exchanges, all standardized derivatives between major market participants shall be traded through clearinghouses, and all derivatives not traded through an exchange or a clearinghouse shall be traded through an OTC trade depository.³⁵⁰ Furthermore, all CDS transactions will be required to meet all the transparency, recordkeeping, anti-fraud, and disclosure requirements regardless of how the transaction is executed.³⁵¹ The SEC and the CFTC have authority to set margin and collateral requirements in relation to the systemic risk posed by the entity and type of derivative transaction; the more systemic risk the greater the margin and collateral requirements.³⁵²

Lastly, Section 10 of the DTADA of 2009 establishes an international working group under the dominion of the ODS.³⁵³ The working group is to analyze the international regulations regarding the harmonization of substantive commodity, securities, and derivative laws.³⁵⁴ The United

346. *Id.*

347. *Id.*

348. *Id.*

349. H.R. 3300, *supra* note 332, at § 6.

350. *Id.*

351. *Id.*

352. *See id.*

353. H.R. 3300, *supra* note 332, at § 10.

354. *Id.*

States' representation in this international working group will consist of three persons; one person from the ODS, SEC, and CFTC.³⁵⁵

The bill establishes a new federal agency that will have to work in tandem with the other federal agencies to develop and enforce CDS regulations. Rather than create one federal agency empowered to monitor and regulate all aspects of financial markets, like accomplished in the United Kingdom, the bill adds a new regulator into the current mix of federal regulators within the United States. So while the ODS has the authority to strictly regulate the CDS market, an additional federal agency may restrain the efficiency of the regulations because of the coordination required for several large bureaucratic entities to effectively administer the law cohesively.

Although the efficiency of regulation may remain unchanged, or even decrease, with the addition of another federal agency, the ODS, SEC, and CFTC are given great deference regarding the creation and implementation of CDS marketplace regulations. As long as these three federal regulators can work in tandem and complement one another's actions, this bill will likely be the first of many federal actions taken to regulate CDS trading, and may be highly productive in doing so.

None of these eight aforementioned pending U.S. congressional laws will absolutely solve the regulatory problems of the current CDS market; however, they are a step in the right direction. Each bill proposes positive initiatives to regulate this opaque market, yet each bill also possesses flaws. Perhaps, only by trial and error of implementing and retracting partial CDS market regulation over time will the U.S. domestic regulatory regime administer effective and efficient CDS regulations that the rest of the world will adopt and enforce.

VIII. AUTHOR'S RECOMMENDATIONS

The first and most important step in regulating the CDS market is to create one, efficient federal financial market regulator. By combining federal regulatory agencies like the OCC, OTS, FDIC, SEC, and CFTC to create one entity, two vital goals can be achieved. First, the United States will have one, authoritative agency that can implement, monitor, and enforce any and all CDS regulations. The current battle between federal agencies for regulatory power is highly unproductive. Also, the current issue of which agency has legal authority over the CDS market will be eliminated, removing regulatory gaps or overlaps while saving resources and promoting efficiency. Second, the United States is the world financial leader. In order for the United States to forge international cooperation and

355. *Id.*

endorse new, international CDS regulatory standards, the United States needs one, coherent voice. Having an organized, efficient, and powerful financial regulator, the United States can ensure the development of CDS regulation in the international community, thus avoiding regulatory arbitrage by CDS market participants.

Therefore, the argument that CDSs should be considered insurance and thus regulated by state insurance regulatory agencies is impracticable. Regulating a financial instrument that is commonly traded among large, international corporations with most transactions spanning national borders by state agencies is a counterintuitive approach. Rather, CDSs require a national standard because implementing international regulation is difficult as is, yet dividing the United States into more than fifty jurisdictions will only make international regulation of the CDS market more complicated and less probable to occur.

Having a limited number of CDS clearinghouses is the next move for efficient CDS regulation. Clearinghouses will bring transparency and standardization to a cloudy market. The clearinghouses will need to require a margin deposit from each CDS party. By requiring every party to post money upfront in order to complete the transaction, the clearinghouses can ensure that the parties maintain a certain level of cash reserves in case of a CDS default. Further, the clearinghouses can gather the margins or collect an additional fee to create a capital reserve of their own as further protection in the event a party defaults on a CDS. Margins and capital reserves will promote market liquidity, especially in times of economic downturn. However, in order for the clearinghouses to truly reduce counterparty and systemic risks, the clearinghouses must accurately value the parties' risk of default to set the correct margin amounts. If the clearinghouses fail to accurately value counterparty and systemic risks, the clearinghouses will fail to reduce risk, and may even aggravate certain risks.

The clearinghouses will serve as an entity that can collect, organize, and report data on CDS transactions, parties, and the market as a whole. By requiring that all CDS transactions be recorded with a clearinghouse, all CDS transaction data will be concentrated at a few entities. The clearinghouses will be capable of aggregating the data and reporting it to the federal regulator, as well as publishing the data for use by investors. Having data on all CDS transactions will greatly increase market transparency, which will improve the accuracy of valuing credit risks. Regulators can efficiently track and monitor all entities involved in the CDS market, and also track and monitor each CDS contract currently outstanding.

Because CDSs are customized contracts designed to suit the parties' specific needs, standardized CDS contracts should not be mandated. The current system, by which the parties may choose certain terms from a given list, permits parties to a CDS to tailor the contract to the given situation and parties' needs. However, by mandating that all CDS transactions be cleared or recorded through a clearinghouse, the market will pick and choose the most valuable and efficient terms in order to decrease transaction costs. Thus, market participants will decide the best terms of a CDS given all parties must transact through a clearinghouse.

Nevertheless, legal definitions used in the CDSs should be determined and enforced by the federal regulator. For example, the parties can determine which type of event will constitute the credit event within the CDS, but the federal regulators have a standard, legal definition of what a credit event can or cannot include. Forcing all CDSs to be a standardized contract will greatly limit the benefit of these contracts and may even drive the market into impracticability.

Rather, leave the market some freedom to customize the contracts but require all transactions to be recorded through a clearinghouse. This will ensure all parties post the margin requirement and that the party is a registered CDS participant. Also, the clearinghouse has the ability to increase the margin for more customized contracts because these highly customized CDSs are less liquid. The federal regulator should have the authority to demand that all clearinghouses and potential parties register with the agency. The regulator will have the authority to set standards by which each party and clearinghouse must meet in order to operate within the CDS market. Not only will the regulator be able to monitor all CDS transactions through the clearinghouse, it will also have the ability to monitor any CDS party's financial records and accounting books.

The netting of CDS transactions should be required and enforced by the clearinghouses because netting will reduce the notional amount due upon settlement, reducing the risk that a party cannot pay the settlement amount, and also reducing the number and total cost of CDS transactions. Also, any type of transfer, sale, novation, or cancellation of a CDS contract should not be legal unless both parties agree to the given transaction and the transaction is recorded with a clearinghouse or directly with the federal regulator. This eliminates the parties' ability to trade CDSs without the regulator's knowledge.

The number of clearinghouses should be limited. Somewhere between three and five clearinghouses should be optimal. A large number of clearinghouses pose several problems. First, the more clearinghouses, the more dispersed the data and the more difficult it is for the federal regulator to collect, organize, and monitor the information and the actions of the

clearinghouses and market participants. Second, clearinghouses need to attract varied types of parties in order to collect a proper amount in margin and collateral requirements to efficiently disperse the risk of default among many parties. Therefore, the clearinghouses need to attract a certain amount of CDS transactions in order to reduce systemic risk by collecting a significant amount of money from these transactions so to efficiently spread risk among all market participants. Finally, the more clearinghouses spread throughout the world, the more resources the international community will need to consume to monitor these facilities.

Also, if a nation fails to adopt the same CDS regulations as the international standard embraces, parties may direct trades through the less regulated facilities. Thus, a small number of clearinghouses located in jurisdictions with very similar, if not the same, CDS regulatory structures will ensure the most efficient collection, organization, and monitoring of the CDS market by forcing all CDS transactions through a legal regime with high levels of oversight.

As to “naked” CDSs, these speculative trades should not be treated as gambling and thus illegal because they benefit the market with increased liquidity and price accuracy of the underlying reference assets, obligations, or entities and credit risk. Speculation can cause problems in any market, but there are several steps that can be implemented to mitigate the costs of “naked” CDS transactions while increasing their benefits.

The clearinghouses will ensure that all speculative CDS transactions are recorded and meet the margin requirements. Speculative positions will be treated the same as hedging positions in regards to the clearinghouse transaction costs and margins. For example, a speculator in the current market with \$10 million can purchase ten \$1 million “naked” CDSs. But if the speculator needs to post a twenty percent margin per contract, plus pay clearinghouse fees of five percent of the contract value, the speculator can now purchase eight \$1 million “naked” CDSs. Having to clear the CDS through a clearinghouse and post a margin will reduce the number of “naked” CDSs in the market because a speculation position is not nearly as cost-effective as they are in the current, unregulated market. Naturally, the mandate of clearinghouses for all CDS transactions will limit the amount of CDS contracts outstanding throughout the marketplace. Furthermore, “naked” CDS transactions make heavy use of standardized CDS contracts, ensuring that “naked” CDSs will be transacted through a clearinghouse.

If parties want to enter a CDS where neither party owns the underlying reference asset, the CDS contract cannot be physically settled, only cash settlement. By requiring “naked” CDSs to be cash settled, these transactions or defaults will not artificially affect the market for the underlying reference asset. This problem arose in the Delphi Corporation

bankruptcy discussed earlier because “naked” CDS holders had to enter the market to buy a large amount of Delphi bonds in order to fulfill the physical settlement requirement for a CDS default. Requiring cash settlements for all “naked” CDS positions will completely avoid the speculators need to buy and sell the reference obligations to fulfill the CDS contract settlement; protecting the market from artificial price movements that threaten investors and financial markets.

As a last resort, the federal regulator should have the authority to intervene in the CDS market in order to protect investors and avoid market fraud or manipulation. A set of standards for this intervention would need to be determined, but the basic idea is that the federal regulator, upon gathering some level of proof, can suspend, limit, or terminate an entity’s ability to transact in the CDS market. Further, the federal regulator can suspend, limit, or terminate a single CDS transaction or group of CDS contracts. The regulator’s ability to intervene is exceedingly important when the underlying reference entity is experiencing financial difficulties because CDS holders will have an incentive to see the entity fail in order to trigger a credit event. However, this regulatory interference should be used as a last resort form of market protection and not as a way to illegalize all CDS transactions.

One final recommendation would require all entities holding CDS contracts to submit a quarterly disclosure to the federal regulator in which the disclosure accounts for every current CDS position in addition to all CDS positions held within the previous five years. The new disclosure would include, *inter alia*, the price paid for the CDS, the current fair value of the CDS, the cash flows due to the CDS position, all parties to the CDS, the reference entity and obligation, and the probability the credit event occurs. Further, the CDS holder would be required to explain the numbers disclosed in a narrative format, such as why the entity entered into the CDS, how the entity evaluates and balances the risks of the CDS, how the CDS could affect the financial health of the company, how the company calculated the probability of the credit event occurrence, and explain the effects of previous CDSs on the company’s financial health. The increased accounting standards would give the federal regulator information, beyond that received from the clearinghouses, to monitor CDS transactions and each entity’s exposure in the market. Information directly from the CDS holders will assist the regulator to locate and control market manipulations and give the regulator a backdrop for future regulatory initiatives.

IX. CONCLUSION

Until the recent financial crisis, CDSs flew under the radar of regulatory agencies and did not gain much of the public’s attention. This

lack of regulation was guaranteed by federal statutes, which kept the market largely opaque and seemingly non-toxic. However, recent discourse has shown the concern held by financial professionals, regulators, academics, politicians, and the public at large regarding CDS transactions. While the U.S. Congress is currently deliberating eight potential laws, none of these eight proposals will solve the currently regulatory gap that the CDS market symbolizes. These eight are a sufficient start for building U.S. CDS regulation, but the CDS market requires more domestic regulation than these bills propose, plus additional international regulations that work cohesively with the domestic initiatives.

Because the CDS market is truly international with no regard to national borders, the U.S. regulation of the market should reflect this characteristic. Therefore, CDS regulation requires more than a federal law or two, but rather a complete regulatory overhaul with a considerable demand for increased informational disclosure. The world continues to look toward the United States for guidance regarding financial markets and investment practices. If the United States does not set a standard which other countries of the world are able and willing to adopt, regulation of CDSs will remain a fictional narrative. Countries that do not adopt regulation will receive an influx of CDS transactions while countries with regulation will see a CDS contraction; so the risks created by CDSs will remain unfettered and flourishing in new host countries. Therefore, the United States must create efficient regulatory standards that the global body politic will adopt and enforce.

CDSs are a very beneficial financial tool for companies that want to reduce credit risk exposure. Their potential to spread risk and increase capital access is abundant, but they can also cause serious economic problems if not used and regulated effectively. Establishing a regulatory system, like the one mentioned in this Note, will protect the benefits of CDSs while curtailing the market abuses of recent years, assuring the CDS market has a worthy, productive future.