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Taming the Wild West of Wall Street: Regulating Credit Default Swaps After Dodd-Frank, 48 J. Marshall L. Rev. 565 (2015)

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TAMING THE WILD WEST OF WALL STREET: REGULATING CREDIT DEFAULT SWAPS AFTER DODD-FRANK

BENJAMIN R. O'CONNOR*

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I. INTRODUCTION

Whenever the Lord raised up a judge for them, he was with the judge and saved them out of the hands of their enemies as long as the judge lived; for the Lord had compassion on them as they groaned under those who oppressed and afflicted them. But when the judge died, the people returned to ways even more corrupt than those of their fathers, following other gods and serving and worshipping them. They refused to give up their evil practices and stubborn ways.¹

* J.D. Candidate, 2015, The John Marshall Law School, Chicago, Illinois; M.A., 2008, Saint Louis University; B.A., 2005, The University of Notre Dame. I want to thank Gregory Riggs and Joseph Swee for their outstanding edits. Their guidance gave coherence to a relatively shapeless mass. I am also grateful to my wife, Elizabeth, for her continuing support throughout law school. There is a special place in heaven for spouses of law students.

Finally, I dedicate this comment to my newborn son, Ryan. May he approach the selfishness, greed, and frailty of the world that he has entered with patience, self-awareness, and laughter, not bitterness. If these should fail, may he demonstrate a healthy dose of righteous indignation.

1. *Judges* 2:18–19.

The calamitous shipwreck of the Great Recession swallowed the fortunes and prospects of many. The crisis also consumed society's trust in the institutions and persons at the helm of the economy. In the half-decade after the twin harbingers of the collapse's onset—the demise of Northern Rock in England² and Lehman Brothers in America³—society has engaged in collective soul-searching.⁴ At the heart of this societal introspection is one question: what went wrong? In response, many have pointed fingers at financial institutions and their leadership.⁵ And

2. See *Northern Rock: Lessons of the Fall*, ECONOMIST (Apr. 18, 2007), <http://www.economist.com/node/9988865> (describing the causes of Northern Rock's demise and ultimate purchase by the British government); Dan Roberts, *The Battle to Save Northern Rock*, THE TELEGRAPH (Sept. 16, 2007), <http://www.telegraph.co.uk/news/uknews/1563265/The-battle-to-save-Northern-Rock.html> (detailing the potential effect of Northern Rock's collapse on the British economy); *Timeline: Northern Rock Bank Crisis*, BBC NEWS (Aug. 5, 2008), <http://news.bbc.co.uk/2/hi/business/7007076.stm> (chronicling specific important dates in the bank's collapse); Alexis Xydias, *Northern Rock Short-Sellers Benefit as Stock Plunges*, BLOOMBERG (Sept. 14, 2007), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akxhm8tobzlk&refer=home> (noting that Northern Rock was “the first major U.K. bank to be bailed out in more than 30 years”).

3. See Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 14, 2008, at A1, available at <http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all> (detailing Lehman's filing for bankruptcy and inability to find a buyer); *The Collapse of Lehman Brothers*, THE TELEGRAPH, <http://www.telegraph.co.uk/finance/financialcrisis/6173145/The-collapse-of-Lehman-Brothers.html> (last visited Nov. 22, 2014) (offering an interactive timeline of the pivotal events in Lehman's demise). For an internal account of the Lehman Brothers bankruptcy see LAWRENCE G. McDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (2009). One of the coauthors, Lawrence McDonald, served as vice president of distressed debt and convertible securities at Lehman Brothers at the time of its demise. He therefore had a front row seat to the actions that led to Lehman's insolvency, as well as the government's unwillingness to bail out the company.

4. See Phillip Inman, *Q&A: The Collapse of Lehman Brothers*, THE GUARDIAN (Sept. 15, 2008), <http://www.theguardian.com/business/2008/sep/15/lehmanbrothers.marketurmoil> (calling the bankruptcy of Lehman Brothers “a repeat of the Northern Rock debacle”); Gordon Rayner, *Credit Crunch Timeline: From Northern Rock to Lehman Brothers*, THE TELEGRAPH (Sept. 15, 2008), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2963415/Credit-Crunch-timeline-From-Northern-Rock-to-Lehman-Brothers.html> (identifying the connection between Northern Rock's demise in 2007 and Lehman Brothers' bankruptcy in 2008).

The two institutions worked together to package and offer sub-prime mortgages, which, as shown *infra*, led directly to their demise. Nicolette Botbol, *Northern Rock Partners with Lehman Brothers to Offer Sub-prime, MORTGAGE STRATEGY* (July 26, 2006).

5. See, e.g., Sewell Chan, *Financial Crisis Was Avoidable, Inquiry Concludes*, N.Y. TIMES, Jan. 25, 2011, at A1, available at <http://www.nytimes.com/2011/01/26/business/economy/26inquiry.html> (noting that the Financial Crisis Inquiry Commission “accuses several financial institutions of greed, ineptitude or both”); *Brits Blame Labour and Their Banks for UK Recession*,

although some financial leaders offered public *mea culpas*,⁶ public indignation at and scrutiny of those in economic power remains strong.⁷ This populist anger is animated by the belief that the intellect, greed, and hubris of those in the financial sector created a dangerous concoction that eventually turned toxic and almost poisoned the entire country.

Since 2008, the public has directed particular enmity at financial instruments called credit derivatives.⁸ Perhaps no form

THE COMMENTATOR (Dec. 20, 2012), http://www.thecommentator.com/article/2300/brits_blame_labour_and_their_banks_for_uk_recession (noting that in a poll of British public, 62% of respondents blamed banking institutions for the country's ongoing recession); Abigail Field, *Who's to Blame for the Mortgage Mess? Banks, Not Homeowners*, DAILY FIN. (Jan. 20, 2011), <http://www.dailyfinance.com/2011/01/20/whos-to-blame-for-the-mortgage-mess-banks-not-homeowners/> (writing that banks knowingly took advantage of potential homebuyers, leading to an influx of sub-prime mortgages that the homeowners upon which the buyers would eventually default).

6. See Alice Gomstyn & Matthew Jaffe, *Bank CEOs Admit Mistakes at Financial Crisis Inquiry Commission Hearing*, ABC NEWS (Jan. 13, 2009), <http://abcnews.go.com/Business/bank-ceos-admit-mistakes-financial-crisis-hearing/story?id=9550511> (reporting on the testimonies of various American bank CEOs before Financial Crisis Inquiry Commission, a bipartisan panel created by Congress to investigate the financial crisis); see also Greenspan Admits "Mistake" That Helped Crisis, NBC NEWS, http://www.nbcnews.com/id/27335454/ns/business-stocks_and_economy/t/greenspan-admits-mistake-helped-crisis/#.Ukmw4-D2CRI (last updated Oct. 23, 2008) (reporting former Federal Reserve Chairman Alan Greenspan's concession that he was mistaken in his belief that banks would "do what was necessary to protect their shareholders and institutions").

7. See, e.g., Jack Kinstlinger, Letter to the Editor, BALTIMORE SUN (July 22, 2010), http://articles.baltimoresun.com/2010-07-22/news/bs-ed-witcover-recession-letter-20100721_1_blame-housing-crisis-residential-mortgage-originations (editorializing that the oversecuritization of private banks in bad mortgages furthered the financial downfall far more than any other factor); Gretchen Morgenson, *Your Money at Work, Fixing Others' Mistakes*, N.Y. TIMES, Sept. 20, 2008, at BU1, available at <http://www.nytimes.com/2008/09/21/business/21gret.html?8dpc> (opining that the taxpayer bailout of major financial institutions like American Insurance Group let the institutions off the hook even though they caused the crisis through reckless investing); Kevin Hassett, *How Democrats Created the Financial Crisis: Kevin Hassett*, BLOOMBERG (Sept. 22, 2008), http://www.bloomberg.com/apps/news?pid=news_archive&sid=aSKSoiNbnQY0 (blaming Democrats for opposing a 2005 bill that would have forced Fannie Mae and Freddie Mac to rid themselves of troublesome housing assets); Paul Steinhauser, *CNN Poll: GOP Takes Brunt of Blame for Economy, Obama Gains*, CNN (Sept. 22, 2008), <http://politicalticker.blogs.cnn.com/2008/09/22/republicans-blamed-obama-gains-over-financial-crisis/> (detailing a 2008 CNN poll in which 47% of polltakers believed that Republican were more responsible for the current financial problems, while 24% said that Democrats were more responsible, 20% blamed both parties equally, and 8% blamed neither party).

8. See *60 Minutes: Financial Weapons of Mass Destruction* (CBS television broadcast Oct. 26, 2008) (transcript available at http://www.cbsnews.com/8301-18560_162-4546199.html) (providing an introduction to credit derivatives and their effect on the financial crisis).

of credit derivative exemplifies the instrument's lure and frightening myopia more than the credit default swap ("CDS"). If credit derivatives are "financial weapons of mass destruction," as Warren Buffett referred to them,⁹ then CDSs are the hydrogen bomb. It is thus not surprising that no credit derivative has been more dragged through the mud.¹⁰ Indeed, CDSs have so vividly grabbed public attention that one commentator dubbed them "the alleged boogeyman of the financial crisis."¹¹

After the groundswell of public anger at financial institutions and the use of credit derivatives, Congress responded swiftly. In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, popularly known as Dodd-Frank.¹² But Congress then abdicated its responsibility to regulators in the Securities Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC").¹³ Indeed, legislators left so much undecided in Dodd-Frank that enforcement divisions of

9. WARREN BUFFETT, ANNUAL LETTER TO SHAREHOLDERS OF BERKSHIRE HATHAWAY INC. 15 (2003), available at <http://www.berkshirehathaway.com/letters/2002pdf.pdf>.

10. See, e.g., Robert Kuttner, *Fixing Wall Street: Abolish Credit Default Swaps*, SEEKING ALPHA (Nov. 1, 2011), <http://seekingalpha.com/article/304133-fixing-wall-street-abolish-credit-default-swaps> (holding that CDSs were too dangerous a practice to even exist, and that no measure of regulation save eliminating them completely would protect consumers from their effects); see also Stephen Gandel, *Why It's Time to Outlaw Credit Default Swaps*, FORTUNE (June 18, 2012), <http://finance.fortune.cnn.com/2012/06/18/credit-default-swaps/> (opining that the JPMorgan Chase bond debacle of the past year—i.e. the poor investments of the so-called "London Whale"—should be the final straw for the legality of CDSs).

11. Reed T. Schuster, *Sacrificing Rationality for Transparency? The Regulation of Swap Agreements in the Wake of the Financial Crisis*, 62 SYRACUSE L. REV. 385, 391–92 (2012).

12. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7 U.S.C., 12 U.S.C., 15 U.S.C., 18 U.S.C., 31 U.S.C., and 42 U.S.C.). For the complete text, see Bill Summary & Status, 111th Cong. (2nd Sess. 2010) H.R. 4173, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@L&summ2=m&#major%20actions> [hereinafter Bill Summary]. The Act is available in PDF form through the Government Printing Office at <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf>. The Dodd-Frank Act was introduced in the House of Representatives as H.R. 4173 on December 2, 2009, and passed in the House on December 11. *Id.* The bill passed the Senate Committee on Banking, Housing, and Urban Affairs by unanimous consent on May 20, 2010, and the entire Senate on the same day. *Id.* The joint Dodd-Frank Act passed House on July 15, 2010. *Id.* President Obama signed the bill into law on July 20, 2010. *Id.* (noting the date of signing). See also Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES, July 22, 2010, at B3, available at http://www.nytimes.com/2010/07/22/business/22regulate.html?_r=0 (detailing the president's signing of the bill and stating "because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes").

13. Title VII of the Dodd-Frank Act specifically deals with the regulation of the swaps market. See §§ 701–74. For a more in-depth discussion of the reforms put into place by the Act, see *infra*, section II(D).

regulatory agencies will ultimately determine the fate of financial reform.

Myriad challenges await the SEC and CFTC. They have the unenviable task of regulating instruments so complex and customized that a single standard will likely not suffice.¹⁴ This challenge will prove even more daunting because these agencies have never regulated any credit derivative, much less a derivative as complicated as the CDS. Yet Congress has demanded that regulators tame the veritable wilderness to protect consumers against fraud and financial malpractice,¹⁵ and do so without handcuffing financial institutions or stifling economic growth. Because Congress largely punted financial reform, these tests must be addressed in the often forgotten but crucial step from legislative pronouncement to executive enforcement.

Although these twenty-first century challenges seem daunting, they are not without precedent. After the implosion of the stock market in 1929 and the onset of the Great Depression, Congress acted to reform the American financial system.¹⁶ Like

14. Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 191 (2011) (noting how proponents of the CDS “laud” the instrument for its ability to aid institutions “with complex investment portfolios to execute customized hedging and risk management strategies”). Even Federal Reserve Chairman Ben Bernanke conceded that, while certain single reference instruments can be simple, “derivatives based on other asset classes—such as exotic interest-rate and foreign-exchange options—can, by contrast, be quite complex.” Ben S. Bernanke, Chairman, Fed. Reserve, Remarks to the Fed. Reserve Bank of Atlanta’s 2007 Financial Markets Conference (May 15, 2007) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm>).

15. See Colleen M. Baker, *Regulating the Invisible: The Case of Over-The-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1298 (2010) (calling the unregulated over-the-counter derivatives market the “Wild West of derivatives regulation”); *SEC Chairman Cox Statement on MOU with Federal Reserve, CFTC to Address Credit Default Swaps*, SEC DIG. 2008-221-1 (Nov. 14, 2008), available at 2008 WL 4901190 (describing SEC chair’s identification of the over-the-counter market in CDSs “virtually unregulated” and call to bring “transparency” and regulation to this market); James Hamilton, *Congress Heeds SEC’s Call For Regulation of Credit Derivatives*, SEC TODAY (Oct. 20, 2008), available at 2010 WL 931230 (explaining how, before Dodd-Frank, CDSs were “traded with virtually no regulation or transparency”).

Many believe that the pendulum has swung too far in the other direction and that heightened regulation has stifled other markets, such as the mortgage market. See, e.g., Nick Timiraos, *Real Time Economics: How Tighter Mortgage Standards Are Holding Back the Recovery*, WALL ST. J. (Sept. 29, 2013), <http://blogs.wsj.com/economics/2013/09/29/how-tighter-mortgage-standards-are-holding-back-the-recovery/> (describing how a former Obama White House policy advisor believes that demand for higher credit standards among potential homebuyers has slowed homeownership in general, and in particular led to higher prices on homes, thus perpetuating a vicious cycle).

16. As President Franklin Roosevelt said in a March 1933 “fireside chat”: “We had a bad banking situation. Some of our bankers had shown themselves either incompetent or dishonest in their handling of people’s funds. They had

Dodd-Frank, the Banking Act of 1933 and the Securities Act of 1934¹⁷ imposed broad economic reforms. Indeed, some of the New Deal financial reforms were unprecedented in American banking¹⁸ and attempted to regulate the previously unregulated.

By examining the history behind the two major financial crises and reform movements of the twentieth and twenty-first centuries, this Comment provides helpful guidelines for regulators tasked with enforcing Dodd-Frank. The Comment has three main sections. Section II explains the nature, regulatory history, and destructive effects of CDSs. That Section then culminates with a description of the structure and CDS-related provisions of Dodd-Frank. Section III details the benefits of and problems with Dodd-Frank's CDS provisions. Section IV outlines the enforcement of Depression-era financial reforms and explains which New Deal practices current regulators should adopt or avoid in their enforcement of Dodd-Frank.

II. BACKGROUND

A. *The Weapons Themselves: Credit Derivatives and CDSs*

In the 1990s, financiers designed complex financial instruments that obtained their value from the credit performance of another entity.¹⁹ These instruments are called credit derivatives. Mixing creativity and financial acuity with old-fashioned teamwork and perseverance, analysts and managers at

used the money entrusted to them in speculations and unwise loans.” 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 64–65 (1938), available at <http://quod.lib.umich.edu/p/pptopus/4925381.1933.001/94?rgn=works;view=image;rgn1=author;q1=roosevelt%2C+franklin>.

17. Pub. L. No. 73-66, 48 Stat. 162.

18. For an overview of banking regulation in the United States before Glass-Steagall, see generally CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES (2d ed. 2005).

19. See generally Shikha Gupta, *Credit Default Swap: Regulations, Changes, and Systemic Risk*, 3 RESEARCH J. OF F. AND ACCOUNTING 27 (2012) (explaining the origins of the CDS). In 1991, personnel at Bankers Trust developed and used a rudimentary version of credit derivatives, specifically a CDS. *Id.* See also Harry Wilson, *A Short History of Credit Default Swaps*, THE TELEGRAPH (Sept. 6, 2011), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8745511/A-short-history-of-credit-default-swaps.html> (noting that “[i]n the early 1990s staff at Bankers Trust . . . and JP Morgan developed the first credit default swaps”). Personnel at JPMorgan, however, perfected the “modern” CDS, and other similar credit derivatives. Michael Mackenzie et al., *JPMorgan Loss Exposes Derivatives Dangers*, FIN. TIMES (May 15, 2012), <http://www.ft.com/intl/cms/s/0/d0ca4bae-9dda-11e1-9456-00144feabdc0.html#axzz2gTfsU9Zw>; Matthew Philips, *How Credit Default Swaps Became a Timebomb*, NEWSWEEK, (Sept. 26, 2008), <http://www.thedailybeast.com/newsweek/2008/09/26/the-monster-that-ate-wall-street.html>.

various banks developed credit derivatives of extraordinary precision and intricacy.²⁰ These inventors hoped that credit derivatives would reduce risk in the market and encourage investing.²¹ And their hope was, at least initially, affirmed; people and institutions invested heavily in credit derivatives, flooding the market with capital.²² In turn, this capital provided the market with that most coveted of attributes: liquidity.²³ Investors even earned higher returns from improved risk diversification.²⁴

20. For a magisterial account of the brief history of credit derivatives, specifically their birth, growth, and decimating effect on the market, see GILLIAN TETT, *FOOL'S GOLD: THE STORY OF J.P. MORGAN AND HOW WALL ST. GREED CORRUPTED ITS BOLD DREAM AND CREATED A FINANCIAL CATASTROPHE* (2010). The book follows the path of the developers of credit derivatives at JPMorgan, explaining their original intent—i.e., to shield the bank from overexposure to risk—and their eventual disillusion with the way in which banks manipulated the instruments for their own greed. *Id.* at 26–38.

21. *Id.* at 21. As Tett notes, “Defaults were the biggest source of risk in commercial lending,” and JPMorgan personnel believed that “banks might well be interested in placing bets with derivatives that would allow them to cover for losses.” *Id.*

22. PRESIDENT'S WORKING GRP. ON FIN. MKT., *OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 4–5* (1999). See also RANGARAJAN K. SUNDARAM, INT'L GROWTH CENTRE, *DERIVATIVES IN FINANCIAL MARKET DEVELOPMENT 6–7* (2012) (describing how the United States credit derivatives market, which was “[l]iterally non-existent 20 years ago,” peaked at \$58 billion in 2007, and still had value of nearly \$30 billion in 2011); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007) (noting that the credit derivatives market has “grown from a small private market in the early 1990s to a liquid, standardized market today”).

23. As Kristen Johnson notes, “Liquidity . . . refers to the ease with which a securities broker may promptly execute a customer's order to acquire or dispose of a security.” Johnson, *supra* note 14, at 188. She adds that “[l]iquidity is among the most celebrated externalities associated with securities exchange networks.” *Id.* And “[b]y allowing financial institutions . . . to increase leverage, credit derivatives can operate to increase the overall amount of liquidity in financial markets.” Arthur W.S. Duff & David Zaring, *New Paradigms and Familiar Tools in the New Derivatives Regulation*, 81 GEO. WASH. L. REV. 677, 686 n.60 (2013). See also Erik F. Gerding, *Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension*, 8 BERKELEY BUS. L.J. 29, 50 (2011) (noting that “[t]he ability of credit derivatives to increase the leverage of financial institutions and the amount of credit that flows into loan markets can translate into increased liquidity, or an increased amount of money, in financial markets”); Partnoy & Skeel, *supra* note 22, at 1024 (stating that because credit derivatives “enable banks to lend at lower risk, these contracts increase liquidity in the banking industry”); Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3099 (2008) (stating that a benefit of credit derivatives is “an increase in liquidity and access of capital because credit default swaps allow banks to pass on risk from making loans”); *Futures/Derivatives/Swaps/Commodities*, 26 BANKING & FIN. SERVICES POL'Y REP. 14 (2007) (noting that “credit derivative products provide liquidity and transparency”).

24. See William F. Kroener III, *SELECT BANKING TOPICS OF CURRENT IMPORTANCE: THE FDIC PERSPECTIVE*, as reprinted in André Scherrer, *Credit*

Ultimately, though, this new form of protection encouraged investors to play as if they would never lose.²⁵

The most popular credit derivative was, and still is, the CDS.²⁶ As a derivative, a CDS derives value from an underlying asset.²⁷ Like all credit derivatives, the underlying asset of a CDS is the credit performance of an individual, corporation, government organization, or sovereign entity.²⁸ Put simply, a CDS is an

Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe, 5 FORDHAM J. CORP. & FIN. L. 149, 150–51 (2000) (calling credit derivatives “sophisticated financial instruments enabling the unbundling and intermediation of credit risk”); see also Scherrer, *supra*, at 150–51 (noting that credit derivatives “can be used to assume or lay off credit risk, in full or to a limited extent”); Wynkoop, *supra* note 23, at 3099 (stating that credit derivatives “can act as a shock absorber during corporate crises”); John T. Lynch, Comment, *Credit Derivatives: Industry Initiatives Supplants Need for Direction Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1391 (2008) (noting that credit derivatives offer “a number of benefits,” including risk diversification).

25. The strong performance of credit derivatives during the 1997 Asian financial crisis led their market to grow “at a phenomenal rate.” Scheerer, *supra* note 24, at 153. Specifically, the use of credit derivatives helped investors recoup at least \$800 million from governmental lending institutions in Korea and Thailand in late 1997 and early 1998. *Id.* at 152. Credit derivatives also aided in the recovering of debt during the 1998 Russian sovereign debt crisis. *Id.* This is the crisis that famously sunk the previously lucrative hedge fund Long-Term Capital Management, which had already been crippled by the Asian crisis in the prior year. See generally ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2000).

26. David Mengle, *Credit Derivatives: An Overview*, 92 ECON. REVIEW (FED. RESERVE BANK OF ATLANTA) 1, 5 (2007) (stating that CDSs “account[] for the vast majority of credit derivatives activity”).

27. MICHAEL DURBIN, *ALL ABOUT DERIVATIVES* 3 (2nd ed. 2010). Durbin calls derivatives “price guarantee[s].” *Id.* See also Sean Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1158 (2012) (describing a derivative as “nothing more than a contractual means by which parties allocate the risk of a fluctuation in price of an underlying reference value”). There are four basic types of derivatives: forwards, futures, swaps, and options. DURBIN, *supra*, at 2. See also Susan M. Mangiero, *ERISA Fiduciaries Beware: Risk Is More Than a Four-Letter Word*, 19-JUN PROB. & PROP. 65 (2005) (describing the various types of derivatives).

Many types of assets can serve as underliers. For example, in an equity derivative, the company in which the investor has purchased a share serves as the underlier. Cindy W. Ma & Algis T. Remeza, *Life Is Full of Derivatives*, 25 FUTURES & DERIVATIVES L. REP. 7 (2005). Additionally, commodities such as oil or silver can be reference entities. Alexander Charap, *Minimizing Risks, Maximizing Flexibility: A New Approach to Credit Default Swap Regulation*, 11 J. BUS. & SEC. L. 127, 130 (2011). Even the performance of a city and its utilities can also serve as the underlier for a derivative. Teresa Dondlinger Trissell, *Derivative Use in Tax-Exempt Financing*, 48 TAX LAW. 1021, 1029 (1995).

28. Douglas B. Levene, *Credit Default Swaps and Insider Trading*, 7 VA. L. & BUS. REV. 231, 233 (2012). See also ROBERT E. LITAN, *THE DERIVATIVES DEALERS’ CLUB AND DERIVATIVES MARKETS REFORM: A GUIDE FOR POLICY*

agreement in which one party, known as a “protection seller,” promises to protect another party, known as a “protection buyer,” from exposure to credit risk.²⁹ Specifically, a “protection seller” promises to pay money to a protection buyer if there is a “credit event” involving the loan. The most basic credit event is a debtor default.³⁰ In reciprocation for protection, the protection buyer makes regular premium payments to the protection seller. These payments can be monthly, quarterly, or semi-annually.³¹ Alan Reschtschaffen, at a 2011 panel on derivative regulation, described the arrangement more colloquially:

So if you and I have a loan outstanding, and I’m worried about your credit risk, I can go to Ken and say, ‘Ken, give me insurance on this.’ I can say, ‘Ken, I will pay you’—and we can structure this in the form of a cash flow . . . and I’ll say to him, ‘I’ll give you a thousand dollars a month for the next 12 months. And if the people out there in the audience default on their obligations, you give me a check for a hundred thousand dollars.’

So after 12 months, if the people in the audience don’t default, then I pay 12 thousand dollars, Ken is 12 thousand dollars richer, and his exposure has ended. However, if the people in the audience default, then Ken has to write me a check for a hundred thousand dollars.³²

Through a CDS, a protection buyer and a protection seller can “swap” the risk present in an underlying loan.³³ Most commonly, a

MAKERS, CITIZENS AND OTHER INTERESTED PARTIES 13 (2010), *available at* http://www.brookings.edu/~media/research/files/papers/2010/4/07%20derivatives%20litan/0407_derivatives_litan.pdf (noting that CDS contracts “are sold on the debt of single companies or countries, on specific issues of mortgage securities, or indices of these instruments”).

29. Mengle, *supra* note 26, at 1. *See also* Griffith, *supra* note 27, at 1160 (noting that a CDS defends against all losses, “real or hypothetical”); Willa E. Gibson, *Clearing and Trade Execution Requirements for OTC Derivatives Swaps Under the Frank-Dodd Wall Street Reform and Consumer Protection Act*, 38 RUTGERS L. REC. 1, 2 n.5 (2010–2011) (describing the “most common form” of a CDS, the “vanilla” CDS).

30. Though the instrument is called a “credit default swap,” a credit event is not limited to default. Mengle, *supra* note 26, at 3. Other events include bankruptcy or restructuring after a buyout. *Id.* at 3–4.

31. Levene, *supra* note 28, at 233.

32. William T. Allen, Panel 1: Derivative Regulation (2011) (transcript available at 7 N.Y.U. J. L. & BUS. 439).

33. In general, a swap is “a contractual agreement between two counterparties to *exchange* future payment streams based on the performance of some underlying market variable.” Charles L. Hauch, *Dodd-Frank’s Swap Clearing Requirements and Systemic Risk*, 30 YALE J. ON REG. 277, 278–79 (2013) (emphasis added). Thus, because a swap, at its roots, relies on the performance of an underlying entity, it is deemed a variable. DURBIN, *supra* note 27, at 2. Other types of swaps include interest rate swaps, currency swaps, and commodity swaps. 6 THOMAS J. MOLONEY ET AL., BUS. & COM. LITIG. FED. CTS. § 70:16 (3d ed. 2013). In an interest rate swap—commonly known as a “plain vanilla” swap—the parties exchange a floating interest rate (e.g., the LIBOR) for a fixed rate. *Id.* A currency swap involves the fixed or

protection buyer will want to purchase a swap when it has, for whatever reason, abandoned hope of profit and merely seeks to ensure repayment of an initial investment.³⁴ Meanwhile, the protection seller becomes a kind of insurance broker, earning some additional capital while providing risk protection.³⁵

Many permutations of CDSs flow from this basic yet highly customizable formula, and these forms can increase in size, stability, and complexity.³⁶ First, the parties must decide what the underlying assets will be. In its simplest and most individualized form, a CDS uses the credit performance of a single corporation or government entity as its underlying reference entity.³⁷ But parties can also use multiple reference entities to create a more sophisticated and stable instrument known as a “basket” CDS.³⁸ In this arrangement, the protection buyer will group together debt obligations, such as loans to corporations in a similar commercial field or utility bonds from a group of similar municipalities.³⁹ This diversification lessens the chance of a single credit event on one loan spoiling the entire portfolio and triggering payment from the protection buyer.⁴⁰ Finally, protection buyers can purchase CDSs on the index level. This entails grouping together a vast amount of

floating exchange rate for national currencies (e.g., U.S. dollars for pounds or Euros), and a commodity swap involves the exchange of fixed and floating rates on a specific underlying commodity (e.g., oil). *Id.*

34. Mengle, *supra* note 26, at 2.

35. *Id.* Of course, as the risk of a CDS decreases, the premium price—or “spread”—falls accordingly. *Id.* at 5.

36. As Tett notes, the complexity of some CDSs exceeded the grasp of many people in finance. TETT, *supra* note 20, at 99. She writes, “These complex products could not be analyzed with just a pen and a piece of paper, or even a handheld computer or two. The debt was being sliced and diced so many times that the risk could be calculated only with complex computer models.” *Id.* See also Hilary J. Allen, *Cocos Can Drive Markets Cuckoo*, 16 LEWIS & CLARK L. REV. 125, 128–29 (2012) (encouraging regulators to use “some creative thinking” to standardize and contain the various permutations of so-called contingent-convertible capital instruments (“cocos”), of which CDSs are a form).

37. Mengle, *supra* note 26, at 3.

38. Johnson, *supra* note 14, at 194; Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 736 (2008).

39. Johnson, *supra* note 14, at 194.

40. Janis Sarra, *Global Market Destabilization and the Role of Credit Default Swaps: An International Perspective on the SEC’s Role Going Forward*, 78 U. CIN. L. REV. 629, 630 n.4. A basket CDS can have a variety of trigger mechanisms. Norman Menachem Feder, *Deconstructing the Over-The-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 710 (2002). One mechanism is the “first-to-default” feature, where default of one of the basket assets triggers payment by the protection seller. *Id.* Another is the “green bottle feature” which bases the level of protection on the relative size of the individual assets in the basket. *Id.* Finally, a CDS may have a “materiality threshold,” a liquidated damages-esque feature where payment is triggered when the protection buyer experience a pre-set amount of loss. *Id.*

diverse debts.⁴¹ Much like equity, commodity, or bond indexes, index CDSs are attractive because they simultaneously present the highest level of diversification and the lowest level of risk.⁴² This final form of CDS was the most popular during the years before the financial crisis.

CDSs can also be customized when defining what qualifies as a “credit event” sufficient to compel payment from the protection buyer.⁴³ Although CDSs are called credit *default* swaps, CDS agreements do not limit credit events to mere default.⁴⁴ Events such as a bankruptcy, a buyout, or a debtor downgrade can trigger payment.⁴⁵ The parties have complete discretion when defining “credit event.”

A few other characteristics of the CDS and its market deserve mention because they are pertinent to the demonization of the CDS. First, investors in CDSs are almost exclusively institutional.⁴⁶ The debt of an individual is not large enough to merit guarantee from a high-end lender such as a commercial bank.⁴⁷ Second, the underlying reference entity—that is, the

41. See Richard M. Hynes, *Securitization, Agency Costs, and the Subprime Crisis*, 4 VA. L. & BUS. REV. 231, 236 (2009) (noting that the index CDS developed in 2006); Levene, *supra* note 28, at 236 (noting that CDSs developed in complexity to reference exchanges indices); Partnoy & Skeel, *supra* note 22, at 1031 (offering the Dow Jones iTraxx as an example of an index-based CDS).

42. Levene, *supra* note 28, at 236 (stating that index CDSs are “the most liquid and most common form of credit default swaps”); Partnoy & Skeel, *supra* note 22, at 1031 (noting that index CDS are attractive because of their low cost). Often, the swap includes more than one party. M. Todd Henderson, *Credit Derivatives are Not “Insurance,”* 16 CONN. INS. L.J. 1, 10 (2009).

43. Robert S. Bloink, *Does the Dodd-Frank Wall Street Reform Act Rein in Credit Default Swaps? An EU Comparative Analysis*, 89 NEB. L. REV. 587, 594–96 (2011).

44. Dante Altieri Marinucci, *Empty Creditor Syndrome and Viviseulture: Preventing Credit-Default-Swap Holders from Pushing Companies into Premature Graves by Refusing to Negotiate Restructuring*, 62 CASE W. RES. L. REV. 1285, 1313 (2012).

45. In the CDS’s early years, a restructuring of the company often qualified as a credit event. Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 52 (2011). It is worth noting, however, that after the repeal of Glass-Steagall in 1999 and the mergers of many banks in late 1999 and the early 2000s, restructuring fell out of vogue as a trigger event for CDS contracts. TETT, *supra* note 20, at 73, 81. For example, in 2003, the ISDA dropped “voluntary debt exchanges”—i.e., a merger—from its definition of CDS trigger events. INT’L SWAPS & DERIVATIVES ASS’N, 2003 ISDA CREDIT DERIVATIVES DEFINITIONS § 4.7(a) (2003). See also Kim, *supra* note 38, at 791 (explaining that the ISDA’s change only allows a merger to trigger repayment when all individual bondholders agree and it “is impossible for every bondholder to participate in a debt exchange”).

46. Seema G. Sharma, *Over-The-Counter Derivatives: A New Era of Financial Regulation*, 17 L. & BUS. REV. AM. 279, 290–91 (2011).

47. Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 200 (2009).

debtor—is not a party to the contract and, thus, does not need to consent to the CDS.⁴⁸ Third, during the early 2000s, parties stopped securing, or “funding,” CDSs by providing the entire value of the outstanding loan in the case of a credit event.⁴⁹

B. Deference to the Creators: Classification and (Non)Regulation

Since the CDS’s invention in the early 1990s, proponents have been wary of government regulation.⁵⁰ Three factors motivated their concern. First, the highly customizable nature of CDSs belied any form of standardized regulation.⁵¹ No CDS is the same because each has a particular type of debt at issue and particular credit events that trigger payment.⁵² Only the parties to the agreement know how much protection they should have, what the appropriate spread should be, and what the definition of credit events should be.⁵³ Therefore, a uniform standard would not work for all CDSs.⁵⁴ Regulation, however, requires standardization, and standardization forced by regulators would create an administrative nightmare for market participants. It would also undercut the very purpose of CDSs.⁵⁵ Thus, market participants argued, regulation would have a chilling, not stimulative, effect on the CDS market.⁵⁶

48. Mengle, *supra* note 26, at 18–19.

49. *Id.* at 2–3.

50. MATTHEW SHERMAN, CTR. FOR ECON. POLICY RESEARCH, A SHORT HISTORY OF FINANCIAL DEREGULATION IN THE UNITED STATES 10–11 (2009), available at <http://www.cepr.net/documents/publications/dereg-timeline-2009-07.pdf> (describing Brooksley Born’s failed efforts to regulate CDSs when she was chairwoman of the CFTC in the 1990s).

51. Levene, *supra* note 28, at 242 n.43 (stating that “[c]ustomized credit default swaps . . . are not suitable for central clearing”).

52. Wynkoop, *supra* note 23, at 3098 (noting that the CDS market is a “noncentralized market composed of individualized, privately negotiated contracts”).

53. See Daniel Hemel, *Empty Creditors and Debt Exchanges*, 27 YALE J. OF REG. 159, 162 (2010) (describing how the International Swaps and Derivatives Association—a “private sector trade association”—drafted a “master” CDS agreement that allows for parties to determine the requisite trigger event for payment).

54. Many of the complaints regarding the “clearinghouse” requirement of Dodd-Frank (see *infra* Section III(B)) revolve around this understanding of CDS. See, e.g., Charap, *supra* note 27, at 150 (noting that the customizable and personalized nature of CDS will make them difficult to clear in an exchange-like setting).

55. Seema Sharma notes that the basic attraction of CDSs and other OTC derivatives stems directly from their lack of standardization which makes them “cost-effective and the least burdensome” of derivatives contracts. Sharma, *supra* note 46, at 285.

56. See, e.g., Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575, 1615 (2013)

Financiers also worried that the chameleonic nature of the CDS defied the legal classification necessary for regulation. At first glance, a CDS gives the distinct appearance of insurance: one party insures another for a hoped-against but somewhat predictable event; in exchange, the insured party pays its apparent indemnitor a premium. However, unlike insurance contracts, in which the indemnitee owns the underlying asset, the protection buyer in a CDS contract—i.e. the creditor—does not own the underlying asset of the debtor’s credit performance.⁵⁷ Simply put, the purchaser of the CDS protection has no real “insurable interest” to preserve.⁵⁸ In fact, its pecuniary interest is quite the opposite—it wants the underlying debt to vanish, because the debtor will likely not repay its debt.⁵⁹ Also, because it guarantees a future price or payout, a CDS looks like a futures derivative.⁶⁰ But the CDS defies this categorization too. Just as a debtor’s credit performance is not an “insurable interest,” it is also not a tangible commodity, like oil, gold, or cattle.⁶¹ Thus, a CDS is not a futures contract. Because of its unique qualities, financiers argued that trying to squeeze CDSs into existing classifications, which were clearly poor fits, would be dangerous because institutions used them so heavily to protect against risk.⁶²

Finally, financiers saw the CDS as a risk-shifting measure meant to protect lenders. The earliest phase of the CDS was a “defensive” phase, where institutions created CDSs to defray what they saw as too much risk.⁶³ In short, banks saw no potential for gain on the loans and did not want the risk. Thus, early

(stating that heightened regulation of CDSs—e.g., treating them as insurance—would scare investors away, and “potentially dry up liquidity for derivatives markets”).

57. Henderson, *supra* note 42, at 32. As such, insurance law should regulate its activity. *Id.* The institutional creditor, one must remember, takes on debt in the first place in order to make some kind of profit on the eventual payout, from either the interest on the loan or the debtor’s continued business. *Id.* By purchasing CDS protection, the creditor, in the words of David Mengle, “effectively gives up the opportunity to profit from exposure to the reference entity.” Mengle, *supra* note 26, at 3. The protection purchased in a CDS is thus not an end unto itself, as is the case with insurance, but instead a means to the ultimate end of profitability for the creditor institution. *Id.*

58. *Id.* For virtually the same reasons, a CDS also does not qualify as security that is tradable on the open market. For example, a futures contract may guarantee 500 barrels of oil for \$1,000 a barrel in three years, regardless of the actual value of a barrel of oil on that date. *Id.* A CDS contract guarantees the payout of a loan by a specific date, regardless of whether the debtor has fulfilled its end of the duty. *Id.*

59. Henderson, *supra* note 42, at 32.

60. DURBIN, *supra* note 27, at 3. A futures contract guarantees a commodity or asset at a particular price at a fixed future date. *Id.*

61. Henderson, *supra* note 42, at 32.

62. See Partnoy & Skeel, *supra* note 22, at 1023–24 (identifying the hedging of risk as a chief benefit of CDSs).

63. CHARLES SMITHSON, CREDIT PORTFOLIO MANAGEMENT 6 (2003).

proponents of the CDS classified it as a defensive instrument that was less perilous than alternatives and less likely to be exploited by speculative investors. And they argued that regulation of the CDS was unnecessary.

Accordingly, financiers warned regulators against advanced oversight.⁶⁴ They claimed that, instead, their own expertise and understanding of the CDS could guide and stabilize the market.⁶⁵ Convinced, legislators and regulators obliged.⁶⁶ Because of this non-regulation, the over-the-counter (“OTC”) market was the only place to buy and sell derivatives. In this OTC market, parties could buy and sell CDSs as they saw fit.⁶⁷ The decision not to regulate, although logical, ignored the dangers lurking below the benign surface: commoditization and speculation.⁶⁸

C. *The Creature Destroys: The Role of CDSs in the Financial Crisis*

It did not take long for investors to see the OTC market as an opportunity.⁶⁹ Instead of using CDSs to run from risk, investors bought CDSs to make money. Knowing that the higher the credit risk, the higher the potential yield on the loan and profit, many

64. Johnson, *supra* note 14, at 222. See also TETT, *supra* note 20, at 23–40 (recounting the full-throated efforts, and eventual victory, of the credit derivatives group at JPMorgan in convincing regulators that credit derivatives were safe financial tools that the government need not regulate).

65. Even within the banks, risk management personnel deferred to others with higher levels of expertise in such instruments. THE FINANCIAL CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 140–41 (2011) [hereinafter FCIC REPORT]. For example, the chief risk officer at Goldman Sachs noted his own deference to underwriting personnel at AIG regarding asset-backed securities and linked CDSs: “They really ticked all the boxes. They were among the highest-rated [corporations] around. They had what appeared to be unquestioned expertise. They had tremendous financial strength.” *Id.*

66. The FCIC Report notes that this deregulation of OTC derivatives continued and was “championed by” persons in positions of political and financial power. See *id.* at xviii (stating that “[m]ore than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards”).

67. See Baker, *supra* note 15, at 1296–97 (explaining the difference between over-the-counter and exchange-traded derivatives).

68. See U.S. DEPT OF JUSTICE, REVIEW OF THE REGULATORY STRUCTURE ASSOCIATED WITH FINANCIAL INSTITUTIONS (2008), available at 2008 WL 345878 at *2 (noting that exchanges have developed new futures contract that “commoditize over-the-counter . . . traded products, particularly interest rate swaps and credit default swaps”).

69. Mengle, *supra* note 26, at 8–10.

became protection sellers on the CDS market.⁷⁰ As protection sellers, investors absorbed debts that they did not believe would experience the triggering credit event.⁷¹ If they chose their reference entities and credit events prudently, investors could collect spread payments without having to pay out any money.⁷² This approach found continued success, leading to increased volume in the CDS market.⁷³

The recognition that the wise investor could game the CDS market triggered not only an influx of overall investment in CDSs, but also an influx of creativity.⁷⁴ This creativity developed into speculative perversion and led to the eventual implosion of the market.⁷⁵ Protection sellers began absorbing credit risks which outstripped their capital on hand.⁷⁶ Instead of funded CDSs, where the protection seller would essentially lend all of the capital upfront,⁷⁷ investors increasingly made “naked” CDS contracts. In these unsecured deals, the protection seller only needed to have capital if the credit event occurred.⁷⁸ As a result, protection sellers, including banks, could take on greater risk without increasing the capital on reserve to guarantee the loan.⁷⁹

In addition, protection buyers deliberately purchased bad debt and then corollary CDS protection.⁸⁰ When default or some other trigger event occurred, the protection seller paid those who cynically invested in the bad debt.⁸¹ Also, because of the lack of regulation, the number of buyers on a bad debt was essentially unlimited.⁸² As one scholar described it:

70. *Id.* at 9.

71. *Id.* at 10.

72. *Id.*

73. FCIC REPORT, *supra* note 65, at 16.

74. *See id.* at 9 (describing the development of synthetic securitization). *See also* TETT *supra* note 20, at 50–53 (explaining the complex “Bistro” synthetic assets developed by JPMorgan’s advanced securities team).

75. As Leo E. Strine writes, “Rank speculation [in the CDS market] was thus the rule, not the exception.” Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 142 (2012).

76. FCIC REPORT, *supra* note 65, at 140. Banks and insurance institutions even lessened the amount of necessary back-up capital for CDS loans. *Id.*

77. Mengle, *supra* note 26, at 3–4.

78. FCIC REPORT, *supra* note 65, at 50.

79. Hemel, *supra* note 53, at 166. *See also* Andrew M. Kulpa, *Minimal Deterrence: The Market Impact, Legal Fallout, and Impending Regulation of Credit Default Swaps*, 5 J.L. ECON. & POL’Y 291, 305 (2009) (identifying “naked” CDS as those without necessary insurable interest); Johnson, *supra* note 14, at 197 (noting how critics of naked CDSs classify the contracts as essentially “gambling arrangements”).

80. Mengle, *supra* note 26, at 15.

81. FCIC REPORT, *supra* note 65, at 50.

82. Gretchen Morgenson & Louise Story, *Banks Bundled Bad Debt, Bet Against It, and Won*, N.Y. TIMES, Dec. 24, 2009, at A1, available at http://www.nytimes.com/2009/12/24/business/24trading.html?pagewanted=all&_r=0.

Let's say there's a guy named Frank and he has a life insurance policy. When he dies, the beneficiary gets a million dollars. Now imagine a whole bunch of other people saying, 'I want a million dollars if he dies, too.' And so they take out life insurance policies on Frank.⁸³

Hence, all of Frank's neighbors can purchase insurance on his life, and all would expect payment when he dies. The ability for an unlimited number of protection buyers or sellers to bet on the same underlying asset created a potentially serious problem. If there were too many credit events on underlying assets that had been sold multiple times, the protection sellers may not have enough capital on hand to pay every protection buyer.⁸⁴ Recognizing this risk, institutions were able to spread the risk even further and delay massive loss through a complex alchemy of diversification and securitization.⁸⁵ This system gave institutions confidence in their ability to isolate losses, pay out CDS loans whose reference entities endured a credit event, and, thereby, maintain liquidity.⁸⁶ This confidence was grossly misplaced.

Speculative investment in CDSs grew exponentially during the 2000's. In 2006, the International Swaps and Derivatives Association ("ISDA") reported that the amount of outstanding CDS protection had grown from \$632 billion to over \$45 trillion in just five years.⁸⁷ The effectiveness of hedging through CDSs and the resulting profits blinded banks. They were confident that this massive bubble would not burst.⁸⁸

83. Alex Blumberg, *Unregulated Credit Default Swaps Led to Weakness*, NPR (Oct. 31, 2008), <http://www.npr.org/templates/story/story.php?storyId=96395271&ft=1&f=94427042>.

84. TETT, *supra* note 20, at 198.

85. Investors accomplished this through innovative instruments known as synthetic collateralized debt obligations ("CDOs"). See FCIC REPORT, *supra* note 65, at 155 (summarizing the use of and spread of CDOs among banking and lending institutions); TETT, *supra* note 20, at 88 (describing the process of creating CDOs at JPMorgan). However, as early as 2005, regulators realized that CDOs enhanced rather than diversified risk. FCIC REPORT, *supra* note 65, at 189.

86. TETT, *supra* note 20, at 201. CDOs were particularly attractive, in the words of Mengle, because they allowed banks to "attain a desired exposure." Mengle, *supra* note 26, at 6. Thus, institutions could unload unwanted debt through well-planned debt structuring. *Id.*

87. Mengle, *supra* note 26, at 7. In 2006, the British Bankers Association reported that the notional amount outstanding on credit derivatives in general had grown from \$180 billion in 1997 to over \$20 trillion in 2006. *Id.* at 11 (citing BRITISH BANKERS ASS'N, BBA CREDIT DERIVATIVES REPORT 2006, at 15 (2006)). From June 2004 to June 2007 alone, the market grew from \$6.4 trillion to almost \$43 trillion. MONETARY AND ECON. DEPT., BANK FOR INT'L SETTLEMENTS, TRIENNIAL AND SEMI-ANNUAL SURVEYS ON POSITIONS IN GLOBAL OVER-THE-COUNTER (OTC) DERIVATIVES MARKETS AT END-JUNE 2007, at 7 (2007).

88. TETT, *supra* note 20, at 201.

They were wrong,⁸⁹ and the burst of subprime mortgage bubble proved the devastating comeuppance.⁹⁰ As more homeowners defaulted on their mortgages, protection sellers guaranteeing these debts through CDSs scrambled to pay the protection buyers.⁹¹ But the loans defaulted faster than protection sellers could come up with the necessary capital.⁹² The effect was precipitous: home loan defaults corrupted other debt obligations with which the banks had packaged the mortgages and led to additional, larger defaults.⁹³ Protection sellers, already massively overleveraged due to the abundance of naked CDSs on their books, could not satisfy huge payouts; they too defaulted.⁹⁴ In what amounted to a highly sophisticated bank run, the chain reaction of default spread to larger institutions, particularly those heavily invested in subprime mortgages and CDSs.⁹⁵

As institutions collapsed, they were purchased by other banks,⁹⁶ bailed out by the government,⁹⁷ or forced into bankruptcy by creditors.⁹⁸ These institutional defaults echoed throughout the financial services industry and the broader western economic system.⁹⁹

D. Hearing the Groans of the People: Outcry Against CDSs and Dodd-Frank

The systemic failures in financial markets had effects that

89. As Tett notes, “by the autumn of 2007, it had become clear that this diversification theory wasn’t working.” *Id.*

90. Tett notes that among JP Morgan personnel and many bankers, “[t]he common assumption was that even if one region suffered a housing bust, the property market would never collapse across the country as a whole.” *Id.* See also Mara Lee, *Subprime Mortgages: A Primer*, NPR (Mar. 23, 2007), <http://www.npr.org/templates/story/story.php?storyId=9085408> (summarizing the major events in the housing crash of 2007, and offering reasons for the crash from various economists and financial analysts).

91. FCIC REPORT, *supra* note 65, at 79 (summarizing the massive amount of defaults on subprime mortgages and the rush among institutions heavily invested in such loans—specifically Merrill Lynch, Citigroup, and AIG—to pay back loans).

92. *Id.*

93. *Id.* at 213.

94. *Id.*

95. *Id.*

96. See *id.* at 382 (detailing Bank of America’s purchase of Merrill Lynch); *id.* at 431 (detailing the Federal Reserve’s coordination of JPMorgan Chase’s purchase of Bear Stearns in 2007).

97. See *id.* at 344–52 (detailing the bailout of AIG).

98. See *id.* at 324–43 (detailing the bankruptcy of Lehman Brothers).

99. Tett recounts the statement of a London senior banker days after the Lehman collapse: “If this continues, the next logical step is that the cash eventually stops coming out of the ATM machines—if that happens, God help us all.” TETT, *supra* note 20, at 238.

spread well beyond Wall Street.¹⁰⁰ And the denizens of Wall Street could not escape the ire of the public. Instead, the public castigated them for their greed, arrogance, and stupidity—essentially, for not seeing the danger of credit derivatives.¹⁰¹ Many believed that financiers had manipulated their way to immense profit, while exposing the entire economy to massive potential losses. The public felt bamboozled and sought blood.¹⁰²

Congress responded to this visceral public sentiment by passing Dodd-Frank. News sources called the bill “the biggest expansion of government power over banking and markets since the Depression”¹⁰³ and claimed that it “would bring about sweeping changes to Wall Street.”¹⁰⁴ The massive legislation

100. Average Americans suffered devastating drops in their net worth. Tami Luhby, *American's Wealth Drops \$1.3 Trillion*, CNN MONEY, http://money.cnn.com/2009/06/11/news/economy/Americans_wealth_drops/?postversion=2009061113 (last updated June 11, 2009, 3:45 PM). Employment also skyrocketed to its highest rate in over fourteen years. Heidi Shierholz, *Unemployment Rate Reaches Highest Level in over 14 Years*, ECON. POL'Y INST. (Nov. 7, 2008), http://www.epi.org/publication/webfeatures_econ_indicators_jobspict_20081107/. The unemployment rate was particularly high among minorities and the less-than-college educated. *Id.*

101. See, e.g., Paul Krugman, *Looters in Loafers*, N.Y. TIMES, Apr. 18, 2010, at A23, available at http://www.nytimes.com/2010/04/19/opinion/19krugman.html?_r=0 (editorializing, in light of an impending civil fraud case against Goldman Sachs, that “much of the financial industry has become a racket—a game in which a handful of people are lavishly paid to mislead and exploit consumers and investors”); Mike Lupica, *Goldman Sachs Building and Ground Zero—Symbols of Greed and Heroism—Are Yards Apart*, N.Y. DAILY NEWS (Apr. 18, 2010), <http://www.nydailynews.com/2.1353/goldman-sachs-building-ground-zero-symbols-greed-heroism-yards-article-1.164577> (contrasting the bravery of the 9/11 first responders with the deception of Wall Street bankers, and comparing the personnel of Goldman Sachs to an organized crime family); Bill Meyer, *Analysis: Washington, Wall Street Blind to Anger*, CLEVELAND PLAIN-DEALER (Feb. 4, 2009), http://www.cleveland.com/nation/index.ssf/2009/02/analysis_washington_wall_stree.html (noting that the continued bonuses paid to top executives at banking institutions shows that “business leaders didn’t seem to get the message” after the 2008 crash).

102. The Occupy Wall Street movement is perhaps the most vivid incarnation of such anger at Wall Street’s corruption. Matt Taibbi, *Wall Street Isn’t Winning—It’s Cheating*, ROLLING STONE (Oct. 25, 2012), <http://www.rollingstone.com/politics/blogs/taibblog/owss-beef-wall-street-isnt-winning-its-cheating-20111025>. As trust in traditional financial institutions collapsed, many consumers took their business to other forms of banking, such as online banks. Catherine New, *As Angry Customers Flee Financial Giants, Online Banks are Booming*, DAILY FINANCE, <http://www.dailyfinance.com/2011/10/06/as-angry-customers-flee-financial-giants-online-banks-are-boom/> (last updated Oct. 7, 2011).

103. Damian Paletta & Aaron Luchetti, *Law Remakes U.S. Financial Landscape*, WALL ST. J., <http://online.wsj.com/article/SB10001424052748704682604575369030061839958.html> (last updated July 16, 2010, 12:01 AM).

104. Silla Brush, *On the Money: Dodd-Frank Bill Would Bring About Sweeping Changes to Wall Street*, THE HILL (June 25, 2010), <http://thehill.com/blogs/on-the-money/corporate-governance/105593-dodd-frank-bill-would-bring-about-sweeping-changes-to-wall-street/>.

spanned and over eight hundred pages and sixteen titles¹⁰⁵ and touched on all areas of finance.¹⁰⁶ Title VII of the Act¹⁰⁷ is of particular importance because it was Congress's first ever attempt to regulate credit derivatives.¹⁰⁸

Dodd-Frank has four principle components for regulating CDSs.¹⁰⁹ First, and most significant, the Act requires that all CDSs clear through exchange-like entities known as public clearinghouses.¹¹⁰ Second, the Act gives vast power to the SEC and the CFTC to regulate various types of swaps, including CDSs.¹¹¹ Third, it requires that all entities involved in CDS contracts register with the agency that regulates that particular type of swap.¹¹² Fourth, the bill forbids the federal government from bailing out any so-called "swap entity."¹¹³ The message from

105. Unformatted, it runs about 2,319 pages. Kevin McCoy, *Dodd-Frank Act: After 3 Years, A Long To-Do List*, USA TODAY (Sept. 12, 2013), <http://www.usatoday.com/story/money/business/2013/06/03/dodd-frank-financial-reform-progress/2377603>.

106. 12 U.S.C. § 5311 (2010).

107. Dodd-Frank, §§ 705–717.

108. Schuster, *supra* note 11, at 1289.

109. Bloink, *supra* note 43, at 606–07.

110. Analysts have dubbed the clearinghouse "the signature regulatory tool of Title VII" of Dodd-Frank. Duff & Zaring, *supra* note 23, at 678.

111. The Act gives the SEC rulemaking power over "security-based swaps," and the CFTC over all other types of swaps. 15 U.S.C. § 8302(a) (2010). The Securities Act describes a "security-based" swap as

[A] swap, as that term is defined under section 1a of the Commodity Exchange Act (without regard to paragraph (47)(B)(x) of such section); and . . . is based on . . . an index that is a narrow-based security index, including any interest therein or on the value thereof; a single security or loan, including any interest therein or on the value thereof; or the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

15 U.S.C. § 78(c)(68)(A). Section 712(a)(8) of Dodd-Frank (codified at 15 U.S.C. § 8302(a)(2)) also grants both entities authority over so-called "mixed swaps," which are security-based swaps that are

[B]ased on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.

15 U.S.C. § 78(c)(68)(D).

112. 7 U.S.C. § 6s. *See also* Marinucci, *supra* note 44, at 1297 (calling the registration requirements "comprehensive").

113. 15 U.S.C. § 8305. *See also* Ann Annette L. Nazareth, *Dodd-Frank Act Finalizes Swap Pushout Rule*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 7, 2010), <http://blogs.law.harvard.edu/corpgov/2010/07/07/dodd-frank-act-finalizes-swap-pushout-rule/> (summarizing the particulars of this so-called "swap pushout rule").

Congress was clear: transparency, good faith, and lack of speculation are the keys to the CDSs' continued existence.

III. ANALYSIS

Instead of banning the CDS, Dodd-Frank chose to drag it from the shadows. In so doing, Title VII of Dodd-Frank creates a "market surveillance system."¹¹⁴ This system allows CDSs to proliferate, though under the watchful eye of regulators. The ultimate goals of this balanced system are to prevent another systemic failure¹¹⁵ and reduce operational risk in the credit derivatives market.¹¹⁶

The section will address the pros and cons of three major aspects of Dodd-Frank's derivative reform: (1) empowering the SEC and CFTC; (2) requiring the use of a clearinghouse; and (3) implementing the set of new registration requirements.¹¹⁷ This

114 . Rosa M. Abrantes-Metz et al., *Revolution in Manipulation Law: The New CFTC Rules and the Urgent Need for Economic and Empirical Analyses*, 15 U. PA. J. BUS. L. 357, 401 (2013).

115. The risk of systemic failure stems from the intense interconnectedness of the players in the financial markets, particularly in the over-the-counter derivatives market. Schuster, *supra* note 11, at 397. The fundamental fear is that the collapse of major dealers would have a "domino effect" leading to widespread failure, as occurred in 2008 with the bankruptcy of Lehman Brothers and the catastrophe that ensued. *Id.* This concern troubles not only the OTC derivatives market, but also the OTC securities, bonds, and options markets, which, as Schuster notes, "are closely tied" to the OTC derivatives market. *Id.*

116. Johnson, *supra* note 14, at 174. Specifically, the Act increases transparency through the clearinghouse and registration requirements, and decreases the risk of cataclysmic failure through the increased presence of the SEC and CFTC. Rosa M. Abrantes-Metz et al., *Revolution in Manipulation Law: The New CFTC Rules and the Urgent Need for Economic and Empirical Analyses*, 15 U. PA. J. BUS. L. 357, 401 (2013). Finally, the "push-out" rule—or more accurately, the "no bailout" rule—will hopefully frighten institutions away from excessive credit exposure, and thereby protect the market as a whole from systemic risk. *Id.* Duff and Zaring suggest that the Dodd-Frank regulatory scheme is "perhaps . . . directed at mitigating instances of extreme 'customer monitoring' during financial panic . . . by reducing ignorance-based information asymmetries." Duff & Zaring, *supra* note 23, at 704.

117. Kress, *supra* note 45, at 61. There are many similarities between CDSs and clearinghouses. Both CDSs and CCPs spread risk; CDSs spread credit risks while clearinghouses distribute overall counterparty risks. *Id.* at 92. The disadvantages are similar as well. CDSs increase interconnection in the financial system, which creates systemic risks, and CCPs, which attempt to reduce interconnections, condense such risk. *Id.*

It is perhaps opportune to give an overview of the "macro-benefits" and "macro-weaknesses" of CDSs in general. The benefits of the CDS are highly interrelated and stem from its primary function: risk management. As described above, institutions can offset or hedge loss on a specific loan by purchasing credit default protection. See *supra*, Part II A. Second, CDSs provide flexibility to institutions. Increased risk protections prevent bad debtors from tying down banks and lending houses and allows such

Comment will not address the swap “push-out” rule because this rule is more future guarantee than present demand.¹¹⁸

A. *The Enforcers: The Increased Power of the SEC and CFTC*

Though Dodd-Frank is extensive in its scope and breadth, its “ultimate impact . . . will depend in large part on the regulations that the CFTC and SEC promulgate.”¹¹⁹ Or, as David Skeel more

institutions to pursue other credit opportunities that they could not otherwise seek. Johnson, *supra* note 14, at 174. Yesha Yadav’s article on clearinghouses, Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO. L.J. 387 (2013), also provides particular clarity on this and related issues. She writes, “The ability to hedge risks [via a CDS] works to reduce capital costs: parties who hedge their risks on a portfolio of loans can set aside less capital to cover the risk of loans that they would otherwise need without the credit derivative.” *Id.* at 403. Third, CDS provide liquidity. Because institutions, freed up from bad loans through CDS protection, are more willing to extend and purchase loans, the market is more fluid. *Id.* This engenders more participation and participants. Liquidity leads then to the fourth and fifth benefits: lower entry and participation costs and better price discovery. Because the market has more parties willing to participate in a credit transaction, institutions will compete for business and offer lower prices to entice potential lenders or debtors. *Id.* Also, because of heightened interest in the CDS market, potential investors will increase research on an underlying asset. *Id.*

However, the financial crisis actualized the potential dangers of CDSs. First is general credit risk—that is, the potential for the credit event defined in the CDS contract language. Kristen Johnson describes “three noteworthy forms” of credit risk as “counterparty risk, default risk, and unrealistic perceptions of credit protection as an absolute guarantee against loss.” Johnson, *supra* note 14, at 206. When myriads of mortgages and other loans defaulted, overleveraged banks and lending institutions felt the blowback and nearly toppled as a result. *Id.* Second, distinct operational risk surrounds CDSs. Because so many CDSs have not traded on exchanges or clearinghouses until Dodd-Frank—and were instead traded OTC—a large number of trades remained backlogged and many of the parties unidentified. *Id.* Such “disorder and obscurity,” as Johnson describes it, “plagued . . . the credit default swap market.” *Id.* Before the financial crisis, such lack of clarity made it difficult to identify areas of overexposure and institutional or systemic risk. Investors and analysts could not detect areas of potential credit weakness and thus would underestimate the potential effect of massive default, such as that which occurred in the subprime housing market. I will discuss the third danger—moral hazard—in note 174.

118. Cynicism, though, has already crept into analysis of Congress’s proclamation not to bail out an institution dealing in CDS. As Sean Griffith notes, “[D]ealers are likely to understand that, regardless of what politicians might say to the contrary, the federal government will not be able to keep itself from bailing out a failing clearinghouse.” Griffith, *supra* note 27, at 1201.

119. Marinucci, *supra* note 44, at 1313. Already, Congress has carved out exceptions to the rule. See Cleary Gottlieb Steen & Hamilton, *Amendments to Dodd-Frank Swaps Push-Out Provision Passed in Omnibus Spending Bill*, (Dec. 17, 2014), <http://www.cgsh.com/files/News/05c69b62-c347-4cea-95f8-7fa6793ad275/Presentation/NewsAttachment/60744270-dd5f-40c0-8f69-8173ea676>

pithily observes, “[i]t all comes down to regulators.”¹²⁰ Because CDSs are derivatives with security-like attributes,¹²¹ Dodd-Frank delegated regulatory power over them to the two agencies most familiar with securities and derivatives.¹²² The SEC, which has express power over the securities market, oversees “security-based swaps.”¹²³ The CFTC, the primary government derivative regulator, oversees all other CDSs. Swaps more often take the form of derivatives, and, thus, usually fit more directly within the CFTC’s expertise.

However, Dodd-Frank does not intend to make government agencies the sole regulators of the CDS market. Dodd-Frank represents the replacement of “the traditional American laissez-faire policy towards derivatives” with “a more European corporatist, safety and soundness paradigm.”¹²⁴ Such a corporatist approach entails “collaboration between the government and large businesses.”¹²⁵ Dodd-Frank encourages this collaboration because its drafters believed the more eyes on the market, the better.¹²⁶ In turn, this scrutiny would provide “far greater potential for voluntary enforcement and compliance by private actors . . . than does some other kinds of banking-style regulation.”¹²⁷ In essence, then, the hope was that the financial industry would regulate itself under government’s watchful eye.

Despite these high-minded goals, three major concerns may trouble the SEC and CFTC as they try to implement Dodd-Frank.

042/Pres.%20Obama%20Signs%20Bill%20Enacting%20Significant%20Amendments%20to%20Swaps%20Push-Out%20Requirements.pdf (describing two recently passed amendments to the swap push-out rule, “significantly broaden[ing] the scope of permitted activity” for depository institutions, while still limited asset-backed swaps).

120. DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 75 (2011).

121. See *supra* at 13–14 text and accompanying notes (discussing the malleable character of the CDS as part-insurance contract, part-security, and part-derivative).

122. For example, each has proposed rules requiring margin levels for uncleared, OTC derivatives. Lucy McKinstry, *Regulating A Global Market: The Extraterritorial Challenge of Dodd-Frank’s Margin Requirements for Uncleared Otc Derivatives & A Mutual Recognition Solution*, 51 COLUM. J. TRANSNATL. L. 776, 798 (2013). This number would be “substantially greater than comparable requirements for cleared derivatives,” and, as a result, “will raise the cost of risk management for uncleared derivatives.” *Id.*

123. As defined by Section 206 of the Gramm-Leach-Bliley Act, security-based swap agreements include any swap agreement in “which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.” Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999), § 206 (current version at 15 U.S.C. § 78(a) (1999)).

124. Duff & Zaring, *supra* note 23, at 699.

125. SKEEL, *supra* note 120, at 11.

126. *Id.* at 65.

127. Duff & Zaring, *supra* note 23, at 703.

First, the regulators simply may be in over their heads.¹²⁸ They failed to perceive the danger of CDSs before the financial crisis and may well make a similar mistake again.¹²⁹ Further, as Barry Le Vine writes, “Never before has [the SEC] been so heavily involved in managing the risk of such complex instruments, which are often . . . difficult to value.”¹³⁰ Though regulators have some expertise in these areas, they often lack the capability to properly value CDSs and their underlying assets or to set appropriate margin requirements.¹³¹ These failures could lead to high amounts of arbitrage if regulators mistakenly value certain credit entities. Private actors with more sophisticated valuation techniques and more skilled valuers would then swoop in and capitalize on the mispricing.¹³²

Second, even if the SEC and CFTC create appropriate *initial* regulations, they may fail to update those regulations fast enough to keep pace with market innovations. As Kristen Johnson notes, “Administrative rule-making processes are notoriously slow” and “there is often a lag as market participants adjust to the rules.”¹³³ As a result, “agile private actors” who notice a regulation in its primitive stages will adjust their practices around the rule. The parties would then avoid punishment when the government finally enacts the regulation.¹³⁴ Thus, financiers can “outmaneuver regulators.”¹³⁵

Third, the emphasis on cooperation between the public and private sectors could lead regulators to cede oversight to the regulated financial institutions themselves. While the SEC and CFTC have extensive power, their financial and intellectual resources cannot match those of major banks and lending houses. Private institutions have greater capability to adapt to market innovations, particularly given the aforementioned “lag” in

128. Some analysts simply believe that the government should not regulate swap agreements at all. *See, e.g.*, Schuster, *supra* note 11, at 394.

129. Edward F. Greene & Joshua L. Boehm, *The Limits of “Name-and-Shame” in International Financial Regulation*, 97 CORNELL L. REV. 1083, 1094 (2012).

130. Barry Le Vine, *The Derivative Market’s Black Sheep: Regulation of Non-Cleared Security-Based Swaps Under Dodd-Frank*, 31 NW. J. INTL. L. & BUS. 699, 701 (2011).

131. *See id.* (asserting that the SEC is incapable of valuing these instruments and thus “should not be in the business of setting margin requirements . . . because it is likely to set them sub-optimally, leading to overtrading and imposing an opportunity cost on the market [i.e., arbitrage]”).

132. McKinstry, *supra* note 122, at 796–97. Analysts express particular concern at the prospect of foreign arbitrage. Le Vine, *supra* note 130, at 722–23 (opining that without some form of “international coordination,” arbitrage of the CDS market by outsiders is quite possible).

133. Johnson, *supra* note 14, at 241–42.

134. *Id.* at 242.

135. SKEEL, *supra* note 120, at 175.

regulatory development.¹³⁶ Aware of their glaring shortfalls, agencies may, out of convenience, slowly empower private institutions to enforce their own rules. Such a relationship, though, would turn financial institutions into the proverbial foxes guarding the henhouses.¹³⁷ Because the effectiveness of Dodd-Frank's derivative reforms "will depend a great deal on the vigilance of the CFTC [and] SEC,"¹³⁸ such voluntary relinquishment of oversight authority would undercut the Act's fundamental promises.

136. Also looming is the ever-present possibility that regulators will not enforce the mandates of Dodd-Frank on prominent institutions. The recent saga of Carmen Segarra, a bank examiner who worked for the Federal Reserve Bank of New York, incarnates this fear. Segarra claims that she was fired for "refusing to back down from a negative finding about Goldman Sachs. Jake Bernstein, *Inside the New York Fed: Secret Recordings and a Culture Clash*, PRO PUBLICA (Sept. 26, 2014), <http://www.propublica.org/article/carmen-segarra-secret-recordings-from-inside-new-york-fed>. Disturbed by the sheepish culture of New York's Federal Reserve, Segarra began secretly recording her colleagues and then released these tapes to the press. *This American Life 536: The Secret Recordings of Carmen Segarra*, NPR (Sept. 26, 2014), <http://www.thisamericanlife.org/radio-archives/episode/536/the-secret-recordings-of-carmen-segarra>. Segarra has claimed that the Federal Reserve has the resources to keep up with banks like Goldman Sachs but lacked "backbone, transparency, thoroughness and perseverance." Jake Bernstein, *So Who Is Carmen Segarra? A Fed Whistleblower*, PRO PUBLICA (Oct. 28, 2013), <http://www.propublica.org/article/so-who-is-carmen-segarra-a-fed-whistleblower-qa>.

137. Edward Greene and Joshua Boehm argue that Dodd-Frank's expansion—and not streamlining—of regulatory agencies has exacerbated the potential for this scenario:

On an organizational level, Dodd-Frank has not only failed to consolidate the already fragmented U.S. regulatory system, but it has also contributed to its further fragmentation, creating several new major bodies—the Financial Stability Oversight Council (FSOC) and Consumer Financial Protection Bureau (CFPB)—within the Federal Reserve Board (FRB), while eliminating only one—the Office of Thrift Supervision (OTS). These agencies supplement the SEC, the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), the FRB, and the FDIC as the principal federal financial regulators in the United States. To complicate matters further, Dodd-Frank also limits the power of federal agencies to preempt state agencies and attorneys general in certain areas of regulation. Taken together, these developments in U.S. financial regulation make for an intriguing inverse of Henry Kissinger's famous statement as U.S. Secretary of State in the 1970s: "If I want to call Europe, who do I call?" Today, European regulators would be forgiven for expressing similar confusion when determining how to coordinate their reforms across America's multitude of agencies.

Greene & Boehm, *supra* note 129, at 1094–95. The sheer number of increased regulators would thus increase regulatory "lag," and create a system too sluggish to keep up with market developments. Johnson, *supra* note 14, at 241–42. To expedite the process of regulation, regulators—too tired to keep up or too confused to know whose job it is regulate a specific development—may simply relinquish control to private regulators. *Id.*

138. SKEEL, *supra* note 120, at 74.

B. Instrument of Stability: The Clearinghouse as Tool for Reform

Clearinghouses are central to Dodd-Frank's derivative reform. A clearinghouse, also known as a centralized counterparty, or "CCP," serves as a mediator between the parties to a transaction.¹³⁹ The clearinghouse collects capital from its members. If a protection seller in a CDS contract fails to pay, the clearinghouse will pay the outstanding debt from its fortified repositories.¹⁴⁰ Through this process, clearinghouses fulfill their basic purpose of protecting their members from credit risk.¹⁴¹

As a third-party intermediary, the clearinghouse validates that payment is proper and ensures that neither party will either unfairly prosper or be hurt by the transaction.¹⁴² Through this

139. Kress, *supra* note 45, at 51. Clearinghouses "connect buyers and sellers of financial contracts, receiving and distributing contractually bound payments." *Id.* See also Ryan Avent, *Derivatives: What's a Clearinghouse*, *ECONOMIST* (Apr. 22, 2010), <http://www.economist.com/blogs/freeexchange/2010/04/derivatives> (comparing the functionality of clearinghouses to the operation of bilateral contracts).

Clearinghouses are not limited in the financial sector. See, e.g., Thomas Schultz, *Does Online Dispute Resolution Need Governmental Intervention? The Case for Architectures of Control and Trust*, 6 N.C. J.L. & TECH. 71, 97–99 (2004) (advocating the use of clearinghouses as a means of coordinating dispute resolution on the Internet); Kourtney Balzer, Note, *A Clearinghouse: The Solution to Clearing Up Confusion In Gene Patent Licensing*, 24 HARV. J.L. & TECH. 519, 529–33 (2011) (suggesting the use of a clearinghouse as a centralized storage and market system for biotechnology patent holders and potential licensees); Mike Butcher, *F6S Becomes a Global Clearinghouse for Startup Freebies, \$100M Worth*, *TECHCRUNCH* (Oct. 17, 2013), <http://techcrunch.com/2013/10/17/f6s-becomes-a-global-clearing-house-for-startup-freebies-100m-worth/> (reporting the development of a clearinghouse specializing in funding technological entrepreneurs); Meredith May, *S.F. Foundation a Funding Clearinghouse*, *SFGATE* (Oct. 17, 2013), <http://www.sfgate.com/bayarea/article/S-F-Foundation-a-funding-clearinghouse-4905482.php> (describing the use of clearinghouses for funding restaurant entrepreneurs in San Francisco); *TransactRx Launches the Nation's First Cross Benefit Clearinghouse*, *PR WEB* (Oct. 23, 2013), http://www.prweb.com/releases/transactrx/poc-network-technologies/prweb112_54583.htm (announcing the inauguration of clearinghouse for vaccinations that coordinates hospitals, doctors, pharmacies, and patients).

140. Timothy P.W. Sullivan, *Swapped Disincentives: Will Clearinghouses Mitigate the Unintended Effects of the Bankruptcy Code's Swap Exemptions?*, 80 *FORDHAM L. REV.* 1491, 1500 (2011).

141. *Id.* The usefulness of the clearinghouse in the derivative market is noteworthy. Specifically, the clearinghouse does not take on any risk with respect to the underlying asset. Griffith, *supra* note 27, at 1175–76. Instead, the purchase position inherited from the original seller is offset by a corresponding selling position with the original buyer. *Id.* The clearinghouse's trades offset automatically, leaving it with zero exposure. *Id.*

142. Federal Financial Institutions Examination Council, *Check Clearing Houses*, <http://ithandbook.ffiec.gov/it-booklets/retail-payment-systems/payment->

work on the transactional level, clearinghouses protect against broader systemic risk.¹⁴³ Banks most prominently use clearinghouses for the processing of customer checks.¹⁴⁴ After the financial crisis, regulators advocated using third-party intermediaries in the derivatives market to protect customers against bank overleveraging and insolvency.¹⁴⁵ Consistent with this request, legislators crafted Dodd-Frank under the assumption that the clearinghouse requirement increases the transparency of CDS contracts and lessens the systemic risk that they present.¹⁴⁶

The benefits of using clearinghouses are manifold. First, clearinghouses “have an impeccable track record for avoiding failure.”¹⁴⁷ Accordingly, they can be well-regarded third parties that connect private financial institutions and can be easily monitored by government regulators.¹⁴⁸ As described above, a clearinghouse prevents systemic failure by mutualizing losses among constituent members. If one entity defaults or its assets lose value, the clearinghouse pays for the loss with other members’ margin contributions.¹⁴⁹ In a large clearinghouse, member entities

instruments,-clearing,-and-settlement/check-clearing-houses.aspx#cite-text-0-3 (last visited Feb. 7, 2015).

143. *Id.*

144. *Id.* Clearinghouses can also process electronic payments. See FEDERAL RESERVE BANK OF NEW YORK, AUTOMATED CLEARING HOUSES (ACHS) (2000), available at <http://www.newyorkfed.org/aboutthefed/fedpoint/fed31.html> (explaining how the Federal Reserve Bank of New York uses automated clearinghouses to process electronic payments).

145. See, e.g., INT’L MONETARY FUND, MAKING OVER-THE-COUNTER DERIVATIVES SAFER: THE ROLE OF CENTRAL COUNTERPARTIES (2010), available at <https://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf> (noting that requiring clearing houses prevents banks from channeling debt from its own books to its customers). The IMF notes that “[t]he main purpose of segregation is to protect customers against the risk that, in the event of the insolvency of their CM [clearing house], the insolvency receiver of the failed CM keeps the customer’s collateral to satisfy the obligations of the failed CM generally, instead of its obligations to the customer.” *Id.* at 14. Thus, clearinghouses protect against moral hazard.

146. 15 U.S.C. § 78(c)(3). See also Charap, *supra* note 27, at 149 (noting that the SEC and CFTC can only clear a CDS transaction if it meets a handful of risk requirements).

147. Kress, *supra* note 45, at 75. See also Randall S. Krozner, *Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearinghouses and Recent Over-the-Counter Innovations*, 31 J. MONEY, CREDIT, & BANKING 596, 598–604 (1999) (tracing the development and precision of clearinghouses through the twentieth century). Clearinghouses “have weathered the Great Depression, the Second World War, failures of major players . . . and high levels of volatility . . . without a collapse.” *Id.* at 601.

148. Griffith, *supra* note 27, at 1155.

149. Kress, *supra* note 45, at 72. There are two forms of margin: initial margin and variation margin. Schuster, *supra* note 11, at 1182. “Initial margin” is the amount of collateral that a member must post to the clearinghouse to clear a trade. *Id.* “Variation margin” is the amount exchanged between the clearinghouse and the trader to reflect changes in value of the

will usually pay little even if a counterparty entirely fails.¹⁵⁰

Second, because the contributing members are essentially insuring one another, individual firms demonstrate self-restraint. “Mutualization instills shared norms”¹⁵¹ whereby participants frown upon the assumption of excessive risk. Such risk endangers all clearinghouse members without providing potential benefit to anyone except the wild gambler.¹⁵² This group dynamic has the effect of either frightening away entities that would recklessly absorb excessive risk or expelling parties that do not heed the rules.¹⁵³ Because clearinghouses have a multiplicity of members, the “well-behaved” members will not tolerate those members who expose them to further risk.

Because of the shared risk, forced use of clearinghouses could have a profound effect on the financial institutions of Wall Street. The CDS market is “a gentleman’s club of the most elite and prestigious financial institutions in the world”¹⁵⁴ and fear of misbehavior and subsequent loss of reputation and business could scare banks into proper behavior.¹⁵⁵ The financial crisis has revealed once again that this “gentleman’s club” cannot regulate itself.¹⁵⁶ However, the introduction of clearinghouse, which would expose any CDS made without proper capital requirements, could spur good behavior. As a result, the clearinghouse can protect society as a whole “against flights of reckless financial fancy that have the potential to take us back into the abyss at any moment.”¹⁵⁷

trader’s position over time. *Id.*

150. The SEC and CFTC vary in their margin requirements. The CFTC requires sufficient capital to enable the clearinghouse to withstand the default of its single largest member while the SEC requires clearinghouses to maintain sufficient financial resources to withstand, at a minimum, a default by the two largest participants. *Id.* Clearinghouses, though, retain wide discretion over how they contemplate risk and design their margin requirements. *Id.*

151. Yadav, *supra* note 117, at 1010.

152. *Id.*

153. *Id.*

154. Johnson, *supra* note 14, at 212–13. See also James Quinn, *Lehman Brothers Crisis Shakes Wall Street’s Corridors of Power*, THE TELEGRAPH (Sept. 14, 2008), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2960312/Lehman-Brothers-crisis-shakes-Wall-Streets-corridors-of-power.html> (calling the world of the Wall Street elite “a gentleman’s club . . . that is impenetrably difficult to get into, and . . . that no one wants to leave”).

155. This could benefit not just the CDS market from systemic collapse, but other markets as well. Yadav, *supra* note 117, at 444.

156. For historical illustrations of the financial industry’s inability to self-regulate, see generally KENNETH ROGOFF & CARMEN REINHART, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009) (chronicling various financial crises and noting that such crises inevitably follow financial booms which create a false sense of security in the economy and infallibility in the financial industry).

157. Yadav, *supra* note 117, at 444.

Third, contracting through a clearinghouse provides other financial benefits. The costs of due diligence for a CDS sold through a clearinghouse will be much lower than for a bilateral OTC contract. A party will only have to investigate the clearinghouse's creditworthiness, not the creditworthiness of the other party.¹⁵⁸ When risks do exist, transparent trading will help parties identify the risks more readily than would be the case in an opaque OTC market.¹⁵⁹ Clearly identifying risks will in turn help to establish a definitive price and will lessen pricing guesswork.¹⁶⁰ This transparency, coupled with government regulation and enforcement, will lead to a more liquid and efficient CDS market.¹⁶¹

Given these benefits,¹⁶² the congressional mandate that CDSs trade via a clearinghouse appears to be a logical solution to the credit derivatives quagmire. However, the CDS presents unique problems that could make use of the clearinghouse difficult. Thus, although clearinghouses often improve the operation of most markets, they may prove unsuitable for the CDS market.

The major problem with CDS contracts is that they are difficult to standardize, and Dodd-Frank avoided "the difficult and nuanced question of what type of products are actually appropriate for clearing."¹⁶³ Given their complexity and highly customizable nature, CDS contracts are "notoriously difficult to value."¹⁶⁴ They will not fit a given clearinghouse standard.¹⁶⁵ One industry professional explained that "one would need to read in excess of 1 billion pages . . . [w]ith a PhD in mathematics under one arm and a [d]iploma in speed-reading under the other" to understand CDSs.¹⁶⁶ Indeed, "[e]very swap transaction is unique, like a snowflake, and you can't make snowflakes with a cookie cutter."¹⁶⁷

The "one size fits all" approach employed by clearinghouses may not accommodate the CDS. Instead, it could lead to less efficiency and higher costs in the CDS market.¹⁶⁸ The more

158. *Id.* at 410–11.

159. Schuster, *supra* note 11, at 396.

160. Johnson, *supra* note 14, at 237–38.

161. *See, e.g.*, Schuster, *supra* note 11, at 401 (noting the importance of liquidity and efficiency in the CDS market).

162. Yadav, *supra* note 117, at 413–14.

163. Charles L. Hauch, *Dodd-Frank's Swap Clearing Requirements and Systemic Risk*, 30 YALE J. ON REG. 277, 285 (2013).

164. Yadav, *supra* note 117, at 413.

165. Le Vine, *supra* note 130, at 716.

166. *Id.* at 722.

167. Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243, 1323 (2011).

168. Le Vine, *supra* note 130, at 735. Additionally, credit derivative instruments and the extraordinary risks they pose for the clearinghouse are novel to clearinghouses. Yadav, *supra* note 117, at 428. Despite an impressive

complex CDSs become, the less similar they are to one another.¹⁶⁹ And the more customized the agreement, the less likely the clearinghouse will be willing to accept it because the counterparty risk will not be readily identifiable.¹⁷⁰ Additionally, clearinghouses do not have experience or expertise with credit derivatives; currently, there is no clearinghouse specializes in processing credit derivatives. The difficulty of standardizing CDS contracts could cause investors to revert to the OTC market¹⁷¹ because clearinghouses will not clear non-standardized instruments.¹⁷² Many have already called this situation a loophole in the Dodd-Frank derivative reform scheme,¹⁷³ particularly one that creates potential for moral hazard.¹⁷⁴

track record, the unfamiliarity of clearinghouses with credit derivatives, in the words of Yadav, “necessitates a new perspective.” *Id.*

169. *Id.*

170. Johnson, *supra* note 14, at 240.

171. Dodd-Frank has imposed requirements on such contracts—the posting of capital and margin requirements, the real-time price reporting requirements, and the establishment of swap repositories—to regulate their use. Griffith, *supra* note 27, at 1201. However, many believe that such transparency measures are not as sufficient as having such contracts clear through a CCP. *See, e.g.,* SKEEL, *supra* note 120, at 65 (relaying the concern that the failure to allow an over-the-counter CDS market to perpetuate outside of the clearinghouse could be fatal to the Dodd-Frank’s derivative reform measures).

172. *Id.*

173. Peter Eavis, *Volcker Rule’s Proprietary Position on Government Bonds*, WALL ST. J., July 7, 2010, at C14, *cited with approval in* Johnson, *supra* note 14, at 241. Gary Gensler, head of the CFTC, notes that this exception for customized CDS contracts could create an incentive for dealers to use such contracts to avoid transparency regulation. *Regulatory Reform and the Derivatives Market: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry*, 111th Cong. 35 (2009) (statement of Gary Gensler, Chairman, Commodity Futures Trading Commission). As a result, “financial institutions might have to be pulled less than willingly into any initiative to standardize derivatives or to move derivatives from over-the-counter onto an exchange.” *Id.*

174. Simply put, moral hazard exists when individuals have incentives to act in a manner that benefits them personally, but harms society in general. Shaila Dewan, *Moral Hazard: A Tempest-Tossed Idea*, N.Y. TIMES, Feb. 25, 2012, at BU1, *available at* http://www.nytimes.com/2012/02/26/business/moral-hazard-as-the-flip-side-of-self-reliance.html?pagewanted=all&_r=0 (noting also that the belief that the government will bail out an individual or institution may lead that entity to take on risks that it would not normally absorb); Daniel K. Tarullo, Governor, Fed. Reserve. Bd., Address at the Exchequer Club of Washington, D.C.: Confronting Too Big to Fail, (Oct. 21, 2009) (transcript available at <http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm>) (describing the situation where “[c]reditors. . . believe that an institution will be regarded by the government as too big to fail [and] may not price into their extensions of credit the full risk assumed by the institution” as “the very definition of moral hazard”).

Moral hazard has existed in the later iterations of the CDS market. Specifically, the immense profits seen in the CDS market, particularly in the early 2000s, attracted speculators looking for an investment opportunity.

The “highly heterogenous” quality of CDSs poses a problem not only for the individual CDS contracts but also for the broader CDS market.¹⁷⁵ In a highly transparent securities market, the price of a security may change, but the underlying terms of an agreement do not. By contrast, in the credit derivatives market, both the price and the underlying terms may change.¹⁷⁶

Additionally, while the use of clearinghouses may lower the cost of due diligence, this may in turn lead to a lack of vigilance on the part of financial institutions.¹⁷⁷ The enormous amount of credit extended via CDS contracts before 2008 suggests a low level of due diligence and thus basic laziness by financial institutions.¹⁷⁸ Instead, the responsibility for due diligence will fall on the clearinghouse. Given that banks and lending institutions have broader resources than clearinghouses to conduct due diligence, many issues could fall between the cracks. For these reasons, CDSs are not as readily tradable on an exchange or exchange-like facility such as a clearinghouse.¹⁷⁹

Even if clearinghouses could handle CDSs, self-governance could lead to cronyism.¹⁸⁰ Because protection buyers and sellers

Mengle, *supra* note 26, at 8–10. Such investors bought protection on loans whose underlier they felt certain would default, and only sold protection on loans they were certain would not default. *Id.* at 9. Thus, in a perversion of the initial CDS instinct for protection, investors profited from the failure of business and institutions. As one commentator described it, investors would “[b]uy CDS low, push down the underlying (e.g., short it), and take a profit from both.” Richard Portes, *Credit Default Swaps: Useful, Misleading, Dangerous?*, EUROINTELLIGENCE (Mar. 15, 2010), <http://www.voxeu.org/article/credit-default-swaps-useful-misleading-dangerous>. In light of the reforms and suggestions of Dodd-Frank, Wall Street banks could “try[] to persuade regulators two or three years from now that clearing and exchange trading are not suitable or necessary for some new derivative.” SKEEL, *supra* note 120, at 71.

175. Trading credit products, too, poses new legal and regulatory difficulties for clearinghouses. Yesha Yadav notes that “[c]redit risk has always been special in the eyes of the law.” Yadav, *supra* note 117, at 428. Specifically, unlike asset-based markets, CDS markets touch on areas of property and contract law novel to clearinghouse personnel. *Id.* Used to the “esoteric regulatory milieu of the financial markets,” clearinghouses may be blind-sided by the nuances presented by the CDS market. *Id.*

176. *Id.* at 399.

177. Yadav, *supra* note 117, at 431.

178. *Id.*

179. *Id.*

180. Three major reasons exist for not trusting dealers and clearinghouse members to watch out for systemic risk. First, as aforementioned in note 118, banks will operate under the assumption that, despite all promises to the contrary, the government will bail out a failing clearinghouse. Griffith, *supra* note 27, at 1201. Second, dealers are not “cohesive, monolithic entities,” but are instead remote institutions suffering from agency costs in the same way as any other large business would. *Id.* at 1202. Agency costs harm organizations because of the disconnect between the incentives of the actors and interests of those for whom they are acting. *Id.* Third, and quite apart from accounts

are normally large institutions,¹⁸¹ the CDS market has far fewer active participants than the securities or commodities markets.¹⁸² And just five banks already own ninety-five percent of clearinghouses.¹⁸³ The small cadre of institutions who do trade CDSs will have considerable influence over clearinghouse governance. That means this insular group will determine who can become a member of the clearinghouse and which CDSs members can trade.¹⁸⁴ These few institutions, including multinational banks, could abuse their power to turn the existing “gentlemen’s club” into a veritable cabal.

Even if these CDS-specific problems are overcome, the clearinghouse market will likely develop in one of two ways. Both are potentially worrisome. Either one or two major clearinghouses will dominate the market or there will be a “multiplicity of competing clearinghouses.”¹⁸⁵ Clearinghouses “can reduce *but not eliminate* risk.”¹⁸⁶ Under the second option, this truth is of little consequence because the failure of one clearinghouse would have few market effects. But if the market is controlled by a few clearinghouses, any failure could be catastrophic. Even a diversified clearinghouse market presents dangers. Trying to survive against so many competitors, clearinghouses may “race to the bottom” by lowering their prices and margin standards to obtain business.¹⁸⁷ This would make individual clearinghouses less stable and more prone to default.¹⁸⁸ The question then becomes which system regulators and legislators would prefer: a stronger, quasi-federal clearinghouse system with potential for massive failure or a confederation of clearinghouses individually less

suggesting that excessive risk-taking is in fact a mistake that dealers would like but are somehow unable to avoid, shareholders may want banks to take on excessive risk. *Id.* at 1203. Thus, in the new regulatory environment, financial institutions will impose their resources and will on clearinghouses. *Id.* See also Yadav, *supra* note 117, at 415 (noting that conflicts of interest may exist in clearinghouse governance—as is the case with exchange governance—due to the desires of shareholders within individual institutions).

181. Schuster states that the CDS market has “no retail component.” That is, it does not sell to individuals. This is because not enough high wealth individuals are parties to swap contracts. Schuster, *supra* note 11, at 401.

182. *Id.* at 400. Schuster calls this a “much lower ratio of participants to instruments” than seen in the futures or equities markets. *Id.* at 401.

183. Griffith, *supra* note 27, at 1211.

184. Simply put, “nothing happens in OTC derivatives without major dealers blessing the moves.” Yadav, *supra* note 117, at 402.

185. SKEEL, *supra* note 120, at 71–73.

186. Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL’Y 671, 686–88 (2010).

187. SKEEL, *supra* note 120, at 72–73. *But see* Nicholas Turner, *Dodd-Frank and International Regulatory Convergence: The Case for Mutual Recognition*, 57 N.Y.L. SCH. L. REV. 391, 419 (2013) (describing how proponents of the “multiplicity” of clearinghouses approach believe that this system would lead to a “race to the middle” or “to optimality”).

188. *Id.*

stable, but more immune to systemic risk.¹⁸⁹ Dodd-Frank left this question unanswered, and so it seems that the market itself will provide the ultimate answer.

C. *Accountability through Identity: Heightened Registration Requirements*

Dodd-Frank also creates several bright-line entry rules for the CDS market.¹⁹⁰ First, Dodd-Frank imposed registration requirements that “treat the major players in the derivative markets as systemically important financial institutions that must be overseen for safety and soundness in order to prevent another panic.”¹⁹¹ All institutions wishing to trade a type of CDS must register with the government agency overseeing that specific type and the clearinghouse on which that type trades.¹⁹² Clearinghouses themselves must register with the SEC or CFTC.¹⁹³ Then relevant registration information can be provided to the market by clearinghouses through their memberships.¹⁹⁴ These transparency measures will keep government agencies abreast of CDS market participation and inform participating entities of potential business partners.

189. Regulation SB SEF, proposed by the SEC, is an example of a legislation-clarifying rule. 76 Fed. Reg. 10,948 (Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242, 249). The SEC expects that the regulation at its root “create[s] a registration framework for security-based swap execution facilities.” *Id.* at 10,948. First, it establishes a schematic that mandates uses of a CCP if the transactions are the type that the SEC concludes must clear. *Id.* at 10,949. Second, if the swap is subject to the clearing requirement, the parties must execute it on an exchange or on a registered swap execution facility. *Id.* Finally, the parties must report this transaction to a registered swap data repository or the SEC. *Id.* Schuster, however, first contends that such requirements will “cause the already illiquid [CDS] market to become even less accessible.” Schuster, *supra* note 11, at 400. Second, he notes that, despite the overall intent to create a framework for a swap facility, the regulation does not actually delineate the actual characteristics of a swap execution facility. *Id.* at 394.

190. Griffith, *supra* note 27, at 1186.

191. Duff & Zaring, *supra* note 23, at 706.

192. Both the SEC and the CFTC have proposed rules to open clearinghouse membership to all market participants who meets basic financial standards. Griffith, *supra* note 27, at 1177. The CFTC goes further in its requirements by proposing to enjoin clearinghouses from adopting restrictive membership requirements if less restrictive requirements would accomplish the same goal and would not increase collective or individual risk. *Id.* at 1179. The SEC, by contrast, offers the clearinghouse “more discretion in designing its membership requirements.” *Id.* For example, while acknowledging that portfolio size and trading volumes are often not helpful risk indicators, the SEC nevertheless emphasizes that they could factor into admission “as long as they are not absolute bars to entry.” *Id.*

193. THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.5[2][B] (2014).

194. Yadav, *supra* note 117, at 411.

The major concern surrounding clearinghouse registration requirements is that, in time, clearinghouses may only allow the large financial institutions to participate. The SEC's and CFTC's regulations permit clearinghouses to consider potential participants' risk and sophistication when considering—and rejecting—their registration applications.¹⁹⁵ With largely unchecked power to apply vague standards, clearinghouses could effectively diminish competition in the CDS market by excluding small institutions. This exclusion could result from or reinforce the very cronyism problem discussed earlier.

IV. PROPOSAL

As protection against financial illusion or insanity, memory is far better than law.¹⁹⁶

To address Dodd-Frank's implementation problems, regulators should glean lessons from the past. Although CDSs are novel financial instruments and Dodd-Frank's regulatory scheme presents new challenges, regulators have confronted similar problem before. Indeed, financial innovation and regulatory responses are a constant in a capitalist society. Historical precedent laid down by regulators of generations passed can serve as a helpful prism for CDS regulators. In particular, the American economic milieu of the 1920s, much like that of the early- to mid-2000s, was rife with massive speculation,¹⁹⁷ excessive leverage, systemic risks, economic ignorance, and scant due diligence.¹⁹⁸ Of

195. Griffith, *supra* note 27, at 1198.

196. JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929* ix (Houghton Mifflin 1972).

197. For example, investing the stock market was, during this time, not merely the privilege of the wealthy or those who made their living in finance. Indeed, many in the working class had money tied up in the market. As Frederick Lewis Allen states:

The rich man's chauffeur drove with his ears laid back to catch the news of impending move in Bethlehem Steel: he held fifty shares himself on a twenty-point margin. The window-cleaner at the broker's office paused to watch the ticker, for he was thinking of converting his laboriously accumulated savings into a few shares of Simmons. . . .

FREDERICK LEWIS ALLEN, *ONLY YESTERDAY* 315 (1931).

198. See GALBRAITH, *supra* note 2, at 168–94 (attributing the stock market crash primarily to poor wealth distribution, banks overleveraging themselves with securities and bad foreign bonds, low economic intelligence among the middle and lower classes, and general financial irresponsibility in the moneyed class). Galbraith notes that the banking structure was such that “[w]hen one bank failed, the assets of others were frozen,” causing a chain reaction of insolvency. *Id.* at 179. Unabashedly Keynesian, Galbraith criticized the Hoover-era government for emphasizing a balanced budget after the crash. This, in his mind, was “a triumph of dogma over thought” that accelerated America's slide into depression. *Id.* at 186.

course, as with all bubbles,¹⁹⁹ such characteristics only revealed themselves after devastating catastrophe. In the 1920s, the catastrophe was the stock market crash of 1929.²⁰⁰ This extraordinary unwinding of capital, the chain reaction of bank failures, and the extended period of economic famine laid frighteningly bare the skeletons of America's financial closet.²⁰¹ The aggressive response of regulators in the 1930s can be a model for regulators implementing Dodd-Frank's CDS reforms.

In 1933, as in 2008, Congress passed measures designed to resuscitate the country's economy and prevent a future crash. First, the Glass-Steagall provision of the Banking Act of 1933 prohibited commercial banks from participating in investment banking, and vice versa.²⁰² This ban on "proprietary trading"

199. For a general history on financial bubbles and subsequent crises, see generally CHARLES KINDLEBERGER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* (2000) (identifying trends and common characteristics of various financial crises); see also EDWARD CHANCELLOR, *DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION* (2000) (detailing the appeal of financial gain that lies at the root of speculative periods).

200. GALBRAITH, *supra* note 2, at 88–107 (detailing the disintegration of the stock marketing October 1929).

201. As Walter Bagehot writes, "[e]very great crisis reveals the excessive speculations of many houses which no one before suspected." WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 150 (2010). Galbraith notes, "The Coolidge bull market was a remarkable phenomenon. The ruthlessness of its liquidation was, in its own way, equally remarkable." GALBRAITH, *supra* note 2, at 109. Use of instruments like the investment trust had allowed banks and investment firms companies to purchase securities without the necessary back-up assets. Through investment trusts, as with CDSs and their corollary mortgage-backed securities in the 2000s, 1920s lending institutions had, in essence, manufactured securities to sell. By late 1929 and 1930, though, such securities were worth pennies. The "great speculative orgy" of the 1920s (GALBRAITH, *supra* note 2, at 169) had given way to an avalanche of destruction that showed no signs of slowing. As Galbraith notes, "The singular feature of the great crash of 1929 was that the worst continued to worsen." *Id.* at 108.

In response to the crash, people sought answers and dished out extraordinary amounts of blame. Newspapers blamed the bankers, claiming that they had been "practicing the small arts of petty traders," and needed a "legal straight-jacket." MICHAEL PERINO, *THE HELLHOUND OF WALL STREET* 283, 285 (2010). Bankers blamed the natural fluctuations of the market, Republicans blamed Democrats, Democrats blamed Republicans, and the common people blamed everyone with political and financial power. In 1933, Congress appointed New York prosecutor Ferdinand Pecora to investigate the securities practices of banks and hold hearings unveiling his findings. See generally *id.* (recounting Pecora's 1933 investigation from his hiring to the hearings themselves). The subsequent "thrashing" Pecora gave securities and shadow-banking practices—like investment trusts—galvanized public anger towards banks, and opened the door for unprecedented government regulation. GALBRAITH, *supra* note 2, at 286. President Franklin Roosevelt, unlike his more *laissez-faire* predecessors, was happy to oblige, as was Congress.

202. Glass-Steagall has become a metonym for the overall Act and its financial reforms. The actual Glass-Steagall provisions in the Banking Act of

prevented banks from speculating and overleveraging themselves, thereby decreasing systemic risk. Second, Congress created the Federal Deposit Insurance Corporation (“FDIC”), which guaranteed bank deposits up to a set dollar amount.²⁰³ Congress created the FDIC to prevent bank runs, protect smaller local banks, and foster competition.²⁰⁴ Finally, through the Securities Exchange Act of 1934, Congress created the SEC and empowered it to serve as a watchdog over the securities market.²⁰⁵

After the passage of these laws, regulators gave them teeth.²⁰⁶ Crucially, the regulators were people with considerable expertise and experience on their side. Prominent intellectuals, such as Felix Frankfurter and William O. Douglas, not only designed the original legislation²⁰⁷ but also enforced its provisions.²⁰⁸ Successful

1933 are §§ 5, 16, 20, 21, 22 (codified at 12 U.S.C. §§ 64a, 333–36, 338–39, 378). Section 21 of the Glass-Steagall Act states in applicable part: “[I]t shall be unlawful . . . [f]or any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits.” 12 U.S.C. § 378.

203. The FDIC portion of the Banking Act of 1933 incorporated the sections relating to the FDIC into the Federal Reserve Act of 1913, ch. 6, § 1, 38 Stat. 251. Robert W. Norcross, Jr., *The Bank Insolvency Game: FDIC Superpowers, the D’oench Doctrine, and Federal Common Law*, 103 BANKING L.J. 316, 316 n.1 (1986). Banking legislation in 1950 amended § 12B of the Federal Reserve Act and set it forth as a separate act entitled the Federal Deposit Insurance Act. Act of 1950, Pub. L. No. 81-797, 64 Stat. 873 (codified at 12 U.S.C. §§ 1811–32). *Id.*

204. In its own recent words, the FDIC “believes active competition between banks, thrifts and other financial institutions, when conducted within applicable law and in a safe and sound manner, is in the public interest.” FEDERAL DEPOSIT INSURANCE CORPORATION. FEDERAL BANKING LAW REPORTER AGENCY HANDBOOKS AND MANUALS § 12.1 (2004).

205. 15 U.S.C. § 78d.

206. The Glass-Steagall provision dividing commercial and investment banking, it must be noted, needed no further regulation. One cannot further regulate a ban; she can only ensure its enforcement.

207. Before his appointment to the United States Supreme Court, Frankfurter served as dean of the Harvard Law School and was a trusted advisor of President Roosevelt. He was instrumental not only in shaping the language of the Securities Act of 1933, but in recruiting three Harvard law students—James Landis, Benjamin Cohen, and Thomas Corcoran—to help in the Act’s drafting. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 61–63 (2003). Landis would later serve as a founding commissioner on the SEC and its second chair; Cohen would serve a variety of administrations; and Corcoran would become a prominent lobbyist. *Id.* at 64 and 123.

208. Immediately before his appointment to the United States Supreme Court, Douglas served with distinction as chair of the SEC. As Seligman writes, Douglas’s career on the high court “was so long and so controversial that it all but obliterated memory of the achievements during the Roosevelt administration.” *Id.* at 156. Seligman calls this “unfortunate.” *Id.* A bankruptcy law expert by trade, his chief concern as SEC chair was, in his own words, “the preservation of capitalism,” and he was driven by an intense

businessmen, including Joseph Kennedy, served in agencies like the SEC and used their insider status to sell Wall Street on the new regulatory agenda.²⁰⁹ Without the profound intellectual and personal capabilities of regulators, the legislative provisions would have become paper tigers.

With such qualified and high-profile regulators, the government was willing and able to prosecute the high and mighty of Wall Street. Indeed, many prominent financial figures became trophies for regulators. Richard Whitney, the president of the New York Stock Exchange, was a paradigmatic Wall Street banker in appearance, bearing, and personality.²¹⁰ After his company became insolvent, he was arrested and charged with embezzlement. He pled guilty.²¹¹ Similarly, the government pursued Charles Mitchell, president of National City Bank. Although Mitchell defeated the criminal charges against him, he lost a civil lawsuit and was forced to pay the government over one million dollars.²¹² Tough legislation coupled with tough enforcement ensured that no one on Wall Street was untouchable.²¹³

distaste for the elitism of Wall Street culture and the centralization of finance around New York City. *Id.* at 157. Believing bankers to be “among the least socially minded groups in society,” Douglas viewed the financial services industry as one capable of self-regulation as long as its feet were held firmly to the fire. *Id.* at 158. As he later wrote in a letter on investment banking:

My idea was to force them to approve or disapprove in public fashion the practices in the field. I felt that this would accomplish two things: (1) it would help to clean up some of the worst practices which could not stand the light of public endorsement; and (2) it would make the bankers more vulnerable at the hands of the commission and other agencies of the government. They would so to speak be on the spot.

Letter from William O. Douglas to Willis Ballinger (Jan. 21, 1935) (on file with the Libr. of Congress).

209. Kennedy said that the SEC was a “means of bringing new life into the body of the securities business,” but never shied away from the enforcement measures taken against business. PERINO, *supra* note 201, at 301. At first, many were quite critical of Roosevelt’s appointment of Kennedy, thinking it a cynical political move. SELIGMAN, *supra* note 207, at 106. The New Republic called Kennedy’s appointment “grotesque,” and Jerome Frank, then general counsel of the Agricultural Adjustment Administration and a future SEC commissioner, likened the appointment to “setting a wolf to guard a flock of sheep.” THE NEW REPUBLIC, Jul. 11, 1934, at 220. *See also* DAVID E. KOSKOFF, JOSEPH P. KENNEDY A LIFE AND TIMES 59 (1974). Yet Kennedy proved an able chairman. Within the commission, he developed harmonious relationships with fellow—and originally standoffish—commissioners, and established effective agency infrastructure in short time. SELIGMAN, *supra* note 207, at 109. Externally, he used his considerable reputation and political skills to gain regulatory buy-in from fellow financiers, often resorting to shaming tactics to achieve his ends. *Id.* at 114–15.

210. GALBRAITH, *supra* note 2, at 112.

211. He served time in Sing Sing, and—per court injunction—never traded securities again. *Id.* at 116.

212. Mitchell, his reputation and personal finances ruined, later revived his career and died with much to his name. *Id.* at 124.

213. The reach seemed to surprise even President Roosevelt himself, who

In addition to enforcing the law against individual bad actors, regulators implemented systematic reforms to increase transparency and lessen the dangerous risks of the shadow market. Most important, the SEC reined in the over-the-counter securities market through heightened registration measures.²¹⁴ For example, the Securities Act of 1933 required filing an initial disclosure document called a “registration statement” before a public sale of securities could ensue.²¹⁵ After this filing, an entity could still not begin to trade any securities until the SEC approved the registration statement.²¹⁶

The preceding discussion reveals several features of New Deal financial reform. First, the legislation itself laid down austere rules. Second, the government selected regulators who were intelligent and powerful enough to fight. Third, regulators punished those individuals responsible for the crisis. And, fourth, regulators imposed systematic reforms that corralled the over-the-counter market. Collectively, these reforms allowed regulators to federalize financial governance and curtail misconduct in the previously unregulated securities trading.

The New Deal financial reforms show that regulators must instill transparency. This historical precedent should guide regulators implementing Dodd-Frank as they encounter problems with CDS reforms. Unfortunately, today’s regulators have proved timid in comparison. The government has so far been unwilling to investigate, arrest, and try the truly prominent Wall Streeters responsible for the Great Recession. It is one thing to arrest a middle trader like Fabrice Tourre²¹⁷ or conmen like Bernard Madoff or Jordan Belfort.²¹⁸ It is quite another thing to charge

expressed shock at Whitney’s indictment and conviction. Douglas noted in his memoirs that the President, upon hearing that Whitney had pled guilty, exclaimed “Not Dick Whitney!” Indeed, the President appeared almost preoccupied at the news. “Dick Whitney, Dick Whitney,” he lamented, “I can’t believe it.” WILLIAM O. DOUGLAS, *GO EAST, YOUNG MAN: THE EARLY YEARS* 289–90 (1974).

214. SELIGMAN, *supra* note 207, at 142–43. For a detailed description of the history of security registration requirements, see generally THOMAS LEE HAZEN, *FEDERAL SECURITIES LAWS* (2003), available at <https://public.resource.org/scribd/8763780.pdf> (chronicling the various registration measures imposed by statute and the SEC on entities selling securities). Today, the SEC uses a multi-tiered system for registration. *Id.* at 33–35.

215. *Id.* at 3.

216. *Id.* The Exchange Act of 1934 additionally required that publicly traded companies periodically report their gains to the SEC. *Id.* at 3, 6.

217. Tourre, a former Goldman Sachs vice president, lost a civil trial over his involvement in the sale of fraudulent mortgage-backed securities. Peter J. Henning, *The Penalties, and Possible Appeal, for Fabrice Tourre*, N.Y. TIMES (Aug. 2, 2013), http://dealbook.nytimes.com/2013/08/02/the-penalties-and-possible-appeal-for-fabrice-tourre/?_r=0.

218. Many financial bosses have been more adept at avoiding criminal or civil liability. Bryan Burrough & Bethany McLean, *The Hunt for Steve Cohen*, VANITY FAIR, June 2013, available at <http://www.vanityfair.com/business/>

financial masters like Richard Whitney and Charles Mitchell. Missing are powerful regulators in the mold of the “top scholars and market-savvy Wall Street insiders” who “were attracted to Washington” in the 1930s.²¹⁹ Instead, today’s scholars and insiders remain in the private sector because “[t]he pay differential is too stark, as is the lure of being where the action is.”²²⁰ As the post-New Deal reforms demonstrate, regulators must fix their personnel and confidence gaps if they are to truly reform the CDS market.

Regulators face another hurdle because the substantive law that they must implement lacks the teeth of the 1930s legislation. Regulation can often prove difficult in a centralized financial market because the few players will be powerful and there will be no “good” alternative players for regulators to work with. Dodd-Frank could have mitigated centralization by creating an FDIC-equivalent for CDS clearinghouses that would help smaller clearinghouses compete.²²¹ But the Act did not include any such measure. Instead, Dodd-Frank embraced a corporatist approach that will encourage concentration in a few major clearinghouses backed by large banks. This corporatist approach is wholly contrary to the approach of 1930’s legislators and regulators, who had a healthy distrust of banking and its tendency towards excess.²²² Indeed, a watchdog that trusts friend and robber alike is utterly useless.

Because Dodd-Frank handled CDSs with kid gloves, more drastic action may be required. Dodd-Frank will not eliminate the over-the-counter CDS market; it will only slightly curb that shadow market. That means its “market surveillance” system will be feckless for many CDSs. If Dodd-Frank proves so impotent, legislators must then follow the lead of Glass-Steagall, and severely limit which financial institutions can deal in CDSs.

V. CONCLUSION

Time and prosperity dull pain and its hard lessons. This dulling resulted in the untimely death of the prophylactic

2013/06/steve-cohen-insider-trading-case (describing the immense difficulty United States Attorneys have had in bringing insider trading charges against Steve Cohen, founder of the hedge fund SAC Capital).

219. *Id.*

220. SKEEL, *supra* note 120, at 157.

221. The various new agencies or commissions created in Dodd-Frank—*e.g.*, the Consumer Financial Protection Bureau, Investor Advisory Committee, and Office of Financial Research and Federal Insurance Office—aim to protect the individual consumer more than the smaller bank.

222. Years after his chairmanship, Douglas, lamenting the developing bureaucratization and passivity of the SEC, stated that the main difference between the agency of his time and the agency of the present was that “we put in prison a much higher type of person.” SELIGMAN, *supra* note 207, at 265.

measures of Glass-Steagall. In 1999, the American economy was doing well and the Depression was a thing of the past. So, after years of steady erosion, Congress repealed the Glass-Steagall with the passage of the Gramm-Leach-Bliley Act.²²³ When President Clinton signed the new legislation, he declared Glass-Steagall a vestige of a bygone era.²²⁴ A year later, Congress passed the Commodities Futures Modernization Act, deregulating over-the-counter derivatives.²²⁵ These twin bills opened the floodgates to massive institutional investment in CDSs and other credit derivatives.²²⁶ Again, financial institutions, particularly banks, engaged in speculative trading, just as they did in the 1920s. In less than a decade, many of these banks and lending institutions were pushed into or to the brink of bankruptcy because of massive defaults on the assets underlying CDSs which they bought and sold on leverage.²²⁷ Institutions had misjudged the power of CDSs and forgotten lessons past. Handled unwisely, the CDS brought the world to its knees.

The study of the CDSs is not simply a tale of greedy bankers conniving against the common people. Rather, it is a study in human frailty, of creating something that is perhaps too tempting and too volatile for humans to control. The present crisis has

223. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

224. William J. Clinton, President, Remarks by the President at Financial Modernization Bill Signing (Nov. 12, 1999). He stated in relevant part:

It is true that the Glass-Steagall law is no longer appropriate to the economy in which we lived. It worked pretty well for the industrial economy, which was highly organized, much more centralized and much more nationalized than the one in which we operate today. But the world is very different.

Id.

225. Previously, the chairwoman of the CFTC at that time, Brooksley Born, believed that the government needed to regulate credit derivatives. Peter S. Goodman, *Taking a Hard Look at the Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, at A1, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?pagewanted=all&r=0>. However, Treasury Secretary Robert Rubin, Deputy Secretary Lawrence Summers, and Federal Reserve Chair Alan Greenspan strongly opposed the move, saying that such actions “would lead to a financial crisis.” *Id.* They, along with SEC chairman Arthur Levitt, successfully lobbied Congress for deregulation. Charles W. Murdock, *The Big Banks: Background, Deregulation, Financial Innovation, and “Too Big to Fail,”* 90 DENV. U. L. REV. 505, 520 (2012).

226. See BRUCE K. PACKARD & JAMES W. HARRIS, *THE CURRENT FINANCIAL CRISIS TO THE GREAT DEPRESSION* 21 (2008) (dubbing former United States Senator Phil Gramm the father of the 2008 crash due to his pivotal role in passing both bills); see also Brenda Reddix-Small, *Credit Scoring and Trade Secrecy: An Algorithmic Quagmire or How the Lack of Transparency in Complex Financial Models Scuttled the Finance Market*, 12 U.C. DAVIS. BUS. L.J. 87, 96 n.47 (2011) (blaming the two bills with “creating a fractured regulatory system which undermined the ability of the government to identify problem in the financial market”).

227. See *supra* at 15–18 text and accompanying notes.

presented an opportunity for Congress and regulators to crack down on the CDS market as they cracked down on the securities market in the 1930s.

Congress took strong first steps with Dodd-Frank: forcing CDSs to trade on a clearinghouse, giving heightened power to the SEC and CFTC, and increasing registration requirements. The regulators who now have power would do well to heed the lessons of the 1930s. The basics of the reforms are the same, though the instruments are different: eliminate opaqueness; increase transparency; punish those who step out of line. And if Dodd-Frank proves too weak, legislators should proscribe institutions from entering into CDS contracts, as was done with the separation of commercial and investment banking in the 1930s. The SEC and CFTC regulate CDSs with a skeptical eye, ready to strike those who step out of line. The metaphorical shotgun, to paraphrase Alex Berenson, cannot become rusty from disuse.²²⁸ Failure of conviction will cause another bubble and, eventually, another cataclysmic burst.

228. ALEX BERENSON, *THE NUMBER 55* (2004).