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Swaps Ahoy! Should Regulators Voyage into Unknown Waters?

MARC A. HORWITZ*

Risk and volatility have been constants throughout the history of the financial markets. In an attempt to mitigate the effects of market fluctuations on risk-averse parties, private investment firms have sculpted an array of innovative financial instruments.¹ These investment firms vie with each other and with organized exchanges for the investment dollar, offering the allure of a customized and more flexible financial product. The explosion of new financial instruments into the marketplace has fostered heated debate among regulators, scholars, and industry leaders regarding the necessity of regulation for these new products.² Federal regulatory bodies, unable to agree on a single agency to oversee these instruments, have responded with a hodgepodge of statutes and regulations which either exempt the instruments entirely from regulatory domain or skirt meaningful provisions which directly address the potential abuses of this booming market. The sheer size of the market for new financial instruments and the profound impact which this market potentially can wield upon the world economy begs the question of whether an uncoordinated free market approach is the optimal form of regulation. Should the U.S. unilaterally regulate these instruments? If so, who should possess regulatory jurisdiction? And to what degree should the regulatory bodies assert their jurisdictional powers? This note will focus on swap transactions, and will attempt to unmask their current status in the domestic and global regulatory paradigms. Finally, this note will conclude that despite the dearth of regulation, the dynamics of the swap market dictate that more stringent

* J.D. Candidate, 1994, Indiana University School of Law, Bloomington, B.A., 1991, University of Michigan. In light of the constant state of flux of the swap market, I must include the caveat that this note only contains research as of Jan 1, 1994.

1. These "innovative" financial instruments carry the moniker "derivatives" because they derive their value from other assets (e.g., debt, foreign currency, and commodities). While some derivatives trade on organized exchanges, others are customized for purchase and sale over-the-counter (OTC). *Safety and Soundness Issues Associated With Bank Derivative Activities: Hearing Before the House Banking Finance and Urban Affairs Committee*, Federal News Service, Oct. 29, 1993, available in LEXIS, Nexis Library, Federal News Service File, at *3 [hereinafter *House Hearing*].

2. *Id.* at *1.

regulation may not be the outcome-maximizing solution. More importantly, the fact that swap transactions invariably transcend national boundaries demands that any effective regulation be a concert of the global swap community.

I. AN OVERVIEW OF SEVERAL FINANCIAL PRODUCTS

A. *Futures*

Although grain futures have been traded at the Chicago Board of Trade (CBT) since 1848,³ financial futures are a relatively recent innovation. In the 1970's, the Chicago Mercantile Exchange (CME) led a movement among futures exchanges toward creating futures contracts⁴ from various financial instruments. Futures contracts allow parties who plan to dispose of or acquire commodities at a known point in the future to hedge against their risk and guarantee the prevailing market price. Today, exchanges worldwide trade a spectrum of financial futures contracts, including foreign currencies, debt instruments, and market indices, with new contracts sprouting constantly. Futures contracts afford the risk averse party two primary benefits. First, parties to futures contracts need not supply the full contract price upon formation of the contract. Rather, the purchaser and the seller must only fulfill margin requirements while maintaining their open position. Margin requirements amount to a mere fraction of the contract price.⁵ Second, the futures contract insulates both parties from the risk of future price fluctuations. By entering into the contract, the parties lock in the prevailing market price at the time of the transaction as the price that will be paid upon delivery.

Futures contracts contain several features which serve as drawbacks to certain customers seeking an outlet to assume their risk. First, futures contracts are only available for the limited range of products traded on

3. See JONATHAN LURIE, *THE CHICAGO BOARD OF TRADE, 1859-1905*, at 23 (1979). The CBT was founded in 1848, but was not actually incorporated in its present form until 1859. *Id.* at 40. Futures trading from 1848-1859 was chaotic (even relative to current trading) and disorganized. The CBT did not actually function as an organized exchange until 1859. *Id.* at 25.

4. A futures contract obligates a buyer to deliver to a seller a stated amount of a commodity at a fixed price at a specified delivery date. PHILIP MCBRIDE JOHNSON AND THOMAS LEE HAZEN, *COMMODITIES REGULATION*, § 1.03 (2d ed. 1989). See also *infra* text accompanying notes 29-31.

5. See *id.*, at § 1.10; THOMAS A. RUSSO, *REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS*, § 1.20 (1992).

organized exchanges and cannot be altered in any way to fit the particular needs of a party. Second, futures exchanges set the delivery dates for their contracts. Typically, exchanges only list financial futures contracts for delivery on one day every two to three months. Thus, consumers to whom date of delivery is of concern either must hold the commodity until the desired use date or delay the ultimate use date until delivery. Choosing the former can incapacitate a huge capital reserve for the period of the lag if another adequate investment vehicle is unavailable for the interim. Opting for the latter may prove infeasible in light of the underlying purpose of the contract. Third, the futures exchange fixes the amount of the commodity which encompasses each contract.⁶ Exchanges thereby limit the customer to hedging its risk only in an amount that constitutes a multiple of an exchange traded contract.⁷ Finally, exchanges offer contracts for delivery dates which span a relatively short time frame. While contracts with delivery dates one year, and sometimes two years, out from the present exist, typically contracts with delivery dates more than six months out fail to attract sufficient investor attention to provide an active and liquid market.⁸ Thus, the futures contract may not be the ideal outlet for the consumer who desires to mitigate long-term risk.

B. Options

An option is the right, but not the obligation, to buy or sell a prescribed quantity of an asset at a specified price at or prior to a fixed future date.⁹

6. For example, the International Monetary Mart of the CME has fixed contracts for commonly traded currency futures and options futures as follows:

Japanese Yen	1 contract = 12,500,000 Yen
Deutsche Marks	1 contract = 125,000 Marks
Swiss Francs	1 contract = 125,000 Francs
British Pounds	1 contract = 62,500 Pounds
Canadian Dollar	1 contract = 100,000 Canadian Dollars

See WALL ST. J. daily price quotes.

7. The Mid America Commodity Exchange offers smaller contract sizes than other exchanges. For financial futures, contract sizes constitute one-half those of the CME. See *supra* note 6.

8. Crude oil futures are one notable exception. In an attempt to attract swap participants into the futures markets, the New York Mercantile Exchange extended its delivery dates for crude oil futures out to three years, in 1990, up from its previous level of 18 months. Currently, swap traders comprise the bulk of the market in these new contracts. Laurie Morse, *Survey of Derivatives*, FIN. TIMES, Dec. 8, 1992, at IV.

9. Andrew Giles, *Towards Diversification*, in REGULATIONS GOVERNING DERIVATIVES, AN INTERNATIONAL GUIDE 4 (Josephine Carr ed., 1992); JOHNSON AND HAZEN, *supra* note 4 at 22-23.

A call option grants the right to buy an asset; a put option confers the right to sell an asset.¹⁰ In order to garner the right to buy or sell the asset, the option purchaser must pay a premium. If the purchaser decides not to exercise the option and declines to purchase or sell the asset when the option date expires, the purchaser loses only the premium paid.¹¹ The feature of a loss ceiling renders options more attractive than futures to many investors, since futures carry unlimited loss potential. Each major commodity exchange lists options for virtually all commodities it trades. However, options listed on organized exchanges share the same four drawbacks with futures contracts.

Futures and options contracts differ from securities in that futures and options contracts are commonly referred to as a zero-sum game. The contracts and the parties who enter into them create no new wealth. Rather, the contracts merely reallocate risk among the parties.¹² Securities, on the other hand, raise capital for a particular entity. Since these funds are employed for expansion and other productive ends, securities indirectly contribute to the creation of new wealth.¹³

C. Swaps

Since futures and options contracts fail to fulfill the needs of all, investment firms have responded with innovative products which cater to the individual demands of consumers. One such product is a swap transaction,

10. Giles, *supra* note 9, at 4.

11. To illustrate, say X wants to sell 1,000 widgets on June 1 of next year at \$5 per widget. X can enter into an option contract with Y, whereby X promises to pay Y \$100 for the right to sell the 1,000 widgets to Y at \$5 per widget on June 1. \$5 is the strike price, and \$100 (or 10 cents per widget) is the premium for the put option. If, on June 1, the market price of widgets is below \$5, X will exercise the option and sell the 1,000 widgets to Y at \$5. In this scenario, X receives \$5,000 as the contract price, and loses the \$100 premium. If, however, the market for widgets trades above \$5, X may choose not to exercise the option and sell the widgets to Z instead at the market price of, say, \$5.50 per widget. Here, X receives \$5,500 from Z and still loses the \$100 premium to Y. Regardless of how much the market fluctuates, or what course of action X chooses, X can lose no more than \$100 on the option contract. But if the price of widgets on May 1 of next year has fallen so drastically that widget producer Q offers to pay X \$1,000 for the right to sell widgets to Y for \$5 apiece, X makes a profit of \$900 by selling the option to Y, however, as the seller or "writer" of the option contract, X faces unlimited exposure and thus must post and maintain margins as if the transaction were a futures contract.

12. Thomas Lee Hazen, *Public Policy: Rational Investments, Speculation or Gambling?—Derivatives Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 *Nw. U. L. Rev.* 987, 1007-08 (1992).

13. *Id.*

or swap. A swap is a contractual duty to exchange one type of asset for another according to terms which the parties stipulate upon entering into the contract.¹⁴ Interest rate swaps comprise the largest chunk of the swap market.¹⁵ Interest rate swaps involve one party paying an amount of a specified currency at a fixed interest rate and the other party paying an amount of the same currency at a floating rate based on the same principal. The floating rate often corresponds to the London interbank offered rate (LIBOR).¹⁶

Interest rate swaps effectively allow parties with contrasting assets and liabilities to insulate themselves against the risk of fluctuations in interest rates.¹⁷ Institutions with primarily short-term, variable rate liabilities and long-term, fixed-rate assets will face heightened interest payments as interest rates rise. One example of such an institution is a local bank or "thrift" institution. Such entities possess short-term, variable rate liabilities which consist of interest owed to depositors based on interest rates pegged to market rates. If such a bank has lent a sizable portion of these deposits to borrowers at fixed rates (e.g., for home mortgages), it will face an asset-liability mismatch.¹⁸ In contrast, many finance companies issue loans at floating rates and hence possess largely floating rate assets. If such an organization took out fixed rate debt to finance its business, an opposite mismatch results.¹⁹ If interest rates tumble, institutions with fixed rate liabilities and floating rate assets will suffer a decline in interest income. Such an institution can match up with a counterpart with predominantly fixed rate assets and floating rate liabilities in a swap transaction, thereby shielding both from the risk of interest rate fluctuations.

When used as a hedging device, interest rate swaps serve the same basic function as futures and options contracts—to reallocate risk. Yet swaps circumvent the four major drawbacks inherent in contracts traded on futures and options exchanges. Interest rate swaps may also be employed for two additional purposes: to arbitrage differences in capital markets or to access

14. Giles, *supra* note 9, at 4.

15. Daniel P. Cunningham et al., *Interest Rate and Currency Swaps and Related Transactions, in SWAPS AND OTHER DERIVATIVES IN 1992*, at 13 (William P. Rogers, Jr. ed., 1992).

16. *Id.* at 11; Giles, *supra* note 9, at 4. For a more technical analysis, see James Bicksler and Andrew H. Chen, *An Economic Analysis of Interest Rate Swaps*, 41 J. OF FIN. 633 (1986).

17. Cunningham et al., *supra* note 15, at 15.

18. See Henry T.C. Hu, *The Modern Process of Financial Innovation and the Vulnerability of A Regulatory Paradigm*, 138 U. PA. L. REV. 333, 349 (1989).

19. *Id.*

parties to capital resources which would be otherwise unavailable.²⁰ If the swap provides a party with access to capital it otherwise would not have been able to obtain, it serves a function similar to that of a security. While clothed a bit differently than the typical offering of debt or equity, the end result is the same. The party can procure additional resources which it can use to create new wealth. Regardless of its ultimate purpose, the swap transaction itself is a zero-sum game, in that the net effect on both parties of the fluctuations of the interest rates subject to the interest rate swap totals zero.²¹ However, although the swap creates no new value, both parties can benefit by entering into the transaction. Thus, swap transactions uniquely resemble both commodities and securities.

Major investment and commercial banks provide liquidity by maintaining large positions in the swap market.²² Typically, end-users of swap transactions do not swap directly with each other.²³ Instead, they separately conduct swap transactions with the investment firm, which acts as a dealer.²⁴ By providing a ready counterparty to every swap transaction,

20. *Id.* For detailed explanations see Barry W. Taylor, *Swaps: Dealing in Interest Rates, in SWAPS AND OTHER DERIVATIVES IN 1992*, *supra* note 15, at 121-33; Christopher Dean Olander and Cynthia L. Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Laws*, 45 MD. L. REV. 21, 22-27 (1986). Taylor illustrates how interest rate swaps work as an arbitrage device. A is a public company with a Triple-A credit rating. Due to its credit standing, banks will loan A substantial sums at a fixed rate, say 10%. B is a middle market company or a smaller lending institution. Since it cannot boast the credit rating of A, large lenders will be more wary of loaning B capital at a fixed rate. In order to compensate for the risk that B will default on the fixed rate loan, such lenders will provide B with a fixed-rate loan only at 12%. A and B enter into a swap transaction whereby:

—A raises fixed-rate capital at 10%; B raises floating rate capital at LIBOR plus 0.75%.

—In the swap transaction, B pays A 10.5% for the fixed-rate loan; A pays B LIBOR for the floating rate debt. Assuming A originally could have procured the floating rate loan at LIBOR, A earns a 0.5% net gain from the transaction (10.5%-10%). B claims a net benefit of 0.75%. In the absence of the swap transaction, B could only procure fixed rate debt at 12%. As a result of the swap transaction, B's borrowing cost is only 11.25% (10.5% fixed rate borrowing cost on the purchase from A plus a 0.75% loss on the sale of floating rate assets to A). Note that even if A could not procure a fixed rate loan for the same capital at any rate, if B was still willing to go through with the swap, A could gain access to the same fixed-rate capital by entering into a similar swap with B.

Taylor, *supra*, at 124-25. For an explanation of the motivations behind some of the more complex swap transactions employed in the 1990's, see Robert H. Litzenger, *Presidential Address: Swaps: Plain and Fanciful*, 47 J. OF FIN. 831, 841-44 (1992).

21. See Barry W. Taylor, *Running With the Pack: The Collective Behavior of Swap Dealers, in INTEREST RATE AND CURRENCY SWAPS* 45, 56 (1988).

22. Taylor, *supra* note 20, at 124-25. For an indepth analysis of the risks facing the swap dealer, see Hu, *supra* note 18, at 358.

23. Taylor, *supra* note 20, at 124-25.

24. *Id.* Approximately 130 large banks and investment banking firms currently serve as swap

investment firms enable each customer to execute the swap transaction at the time and in the manner which the customer (the end-user) prescribes.²⁵ In addition, investment firms not choosing to assume the risk of taking large positions in the swap market may act as matchmakers for customers seeking a mate in a swap transaction.²⁶

While viewed as exotic, arcane, and esoteric financial instruments only a few years ago,²⁷ swaps have gained widespread acceptance in mainstream financial circles. Multinational corporations and other institutions which face interest rate, currency, or other risks²⁸ have identified swap transactions as the optimal medium for mitigating their existing risk. Despite a dearth of information on the true nature of the risks these transactions entail, large commercial and investment banks have flocked to dealing in swap transactions. Such historically conservative institutions have discovered that the sizable commissions they can earn by dealing in the swap market outweigh the substantial, although largely unquantifiable risk of maintaining a large portfolio of swap transactions and have plunged into the swap market. The volume of interest rate swaps has ballooned at an exponential rate since swaps first appeared in 1982.²⁹ Notional amounts outstanding on interest rate swap contracts have skyrocketed from \$3 billion in 1982 to \$683 billion in 1987 to an estimated \$3 trillion in 1991.³⁰ Nothing signals an impending reversal or slowdown in this trend.³¹

Currency swaps are the pioneer form of swap transaction and remain widely used today. Currency swaps entail one party paying periodic fixed amounts of one currency and the other party paying periodic fixed amounts of a different currency.³² Much like interest rate swaps, currency swaps

dealers. Jerry Knight, *Gramm Moves to Keep "Swaps" Unregulated; Huge Financial Market Is at Stake; Fed, Hill Wary*, WASH. POST., Jan. 13, 1993, at F1.

25. Taylor, *supra* note 20, at 124-25.

26. *Id.*

27. See, e.g., David J. Gilberg, *Regulation of New Financial Instruments Under the Federal Securities Laws*, 39 VAND. L. REV. 1599, 1600 (1986).

28. Today's complex swap transactions permit parties to hedge against almost any imaginable risk, provided a willing counterparty is available.

29. Charles Dropkin et al., *Special Report*, in THE REGULATIONS COVERING DERIVATIVES—AN INTERNATIONAL GUIDE 36 (1992); see also Cunningham et al., *supra* note 15, at 11.

30. See also Cunningham et al., *supra* note 15, at 11.

31. See Dropkin et al., *supra* note 29, at 36.

32. Cunningham et al., *supra* note 15, at 13. Sources estimate the 1992 swap market at \$4 trillion. *CNN Moneyline* (CNN Television Broadcast, Jan. 14, 1993) (transcript available in LEXIS, Nexis Library); *Swap Dealers Hail CFTC Exemption Rule*, REUTER'S, Jan. 14, 1993 (available in LEXIS, Nexis Library).

match parties with conflicting exchange rate risk, with the investment firm acting as the dealer. The primary goal of currency swaps is to hedge against exchange rate fluctuations, although today often they are gowned in complex transactions intimately tailored to the customer's desires to hedge across a series of risks. In 1990, the notional amount of outstanding currency swaps totalled \$1.155 trillion, or approximately one-half of the sum for interest rate swaps for the same year.³³

Both interest rate and currency swaps address the built-in disadvantages of hedging risk by trading futures or options on organized exchanges. Investment firms fit swaps to address the individual demands of their customers.³⁴ Unlike futures and options contracts, exchange-fixed contract sizes and delivery dates do not constrain the customer. The investment firm and the customer will negotiate to arrive at a mutually agreeable quantity and termination date of the swap transaction. Further, lack of liquidity in distant future months imposes no barrier to the swap transaction. Of the currency swaps outstanding on December 31, 1990, over eighty percent were due to mature in more than one year, and over half would not mature for another four years.³⁵ Thus, for the bulk of swap participants, futures and options markets are not the ideal outlets for mitigation of their risk.

II. THE JURISDICTIONAL BODIES

A. *The CFTC*

The Commodity Exchange Act (CEA) confers exclusive jurisdiction upon the Commodity Futures Trading Commission (CFTC) over all commodity futures and options contracts "traded or executed on a contract market or any other board of trade, exchange, or market."³⁶ Section 2(a)(1)(A) defines "commodity" as "all . . . goods and articles . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."³⁷ The CEA fashioned such a broad

33. Cunningham et al., *supra* note 15, at 12.

34. See CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989) [hereinafter CFTC Statement].

35. Cunningham et al., *supra* note 15, at 14. For interest rate swaps, the numbers were similar, but not as striking. Over three-fourths of those outstanding still would not mature within the year. *Id.*

36. Commodity Exchange Act, § 2(a)(1)(A) (codified at 7 U.S.C. § 2 (1988)).

37. *Id.*

definition of the term "commodity" in order to promote innovation of new products, but to ensure that these products fell under the ambit of CFTC regulation.³⁸ The CEA explicitly refrained from defining the terms "futures contract" and "future delivery."³⁹ However, in a policy statement issued in 1989, the CFTC defined "futures contracts" as "contracts for the purchase or sale of a commodity for delivery in the future at a price that is established when the contract is initiated, with both parties to the transaction obligated to fulfill the contract at a specified price."⁴⁰ The policy statement notes several distinguishing features of futures contracts. First, the parties in a futures contract do not aim to transfer the underlying commodity; rather they undertake the contract in order to assume or shift price risk. Second, futures contracts traditionally possess characteristics such as standardized units, margin requirements, clearing firms which guarantee performance of the contracts, centralized market trading, and quotation of prices to the public.⁴¹

Section 4(a) of the CEA restricts the trading of futures contracts to exchanges authorized by the CFTC,⁴² unless the contract "is made on or subject to the rules of a board of trade, exchange or market located outside the United States," or if an exemption is otherwise available.⁴³ Each futures contract must satisfy criteria enumerated in Section 5 before the CFTC will permit the exchange to trade the contract.⁴⁴ Congress mandates the trading of futures contracts on organized exchanges in order to curb excessive speculation and the resulting price of these commodities.⁴⁵ Congress' concern stems from the possibility that without an exchange to monitor daily trading volume, wealthy investors could corner the market in a particular commodity and thus drastically impact its price, adversely

38. Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431, 1448 (1991).

39. JOHNSON AND HAZEN, *supra* note 4, § 1.03.

40. CFTC Statement, *supra* note 34.

41. *Id.*

42. 7 U.S.C. § 6(a) (1988) (*amended by the Futures Trading Practices Act of 1992*, Pub. L. No. 102-546, Sec. 502, 106 Stat. 3590 (Oct. 28, 1992)); *see infra*, part III.A. for a detailed analysis of the FTPA amendments.

43. 7 U.S.C. § 6(a) (1988).

44. 7 U.S.C. § 7 (1988).

45. 7 U.S.C. § 5 (1988) (documenting legislative findings on the public interest served by trading futures on organized markets).

affecting both consumers of the commodity and the integrity of the marketplace.

Section 2(a)(1)(A) exempts from the CEA “transactions in foreign currency, security warrants, security rights . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade.”⁴⁶ This exemption, adopted in 1974, is known as the Treasury Amendment. The Department of the Treasury lobbied for such a provision, arguing that absent the exemption, the CEA would impede the ability of financial institutions to trade foreign currency and other financial instruments among themselves.⁴⁷ The CFTC noted that since other bodies regulate these institutional investors, CFTC governance would be duplicative and beyond the scope of the CEA.⁴⁸ The language of the CEA, coupled with the legislative history of the Treasury Amendment, suggests that all transactions transpiring beyond the boundaries of exchange trading floors lie outside CFTC jurisdiction.⁴⁹ Presently, no court has ruled on the question of whether swap transactions qualify as commodities. Thus, that decision has rested squarely in the hands of the CFTC.

B. The SEC

The Securities and Exchange Commission (SEC) governs all securities except those expressly exempted by the language of the Securities Act of 1933 (1933 Act) or the Securities Exchange Act of 1934 (1934 Act). Section 2(1) of the 1933 Act and Section 3(10) of the 1934 Act define a security as:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract,

46. 7 U.S.C. § 2 (1988).

47. Gilberg, *supra* note 27, at 1608; *see also* Trading in Foreign Currencies for Future Delivery, 50 C.F.R. §§ 42,983 and 42,985 (1985).

48. Russo and Vinciguerra, *supra* note 38, at 1448.

49. Gilberg, *supra* note 27, at 1609; *cf.* Mark D. Young and William L. Stein, *Swap Transactions Under the Commodity Exchange Act: Is Congressional Action Needed?*, 76 GEO. L.J. 1917, 1925 (1988) (noting that the CFTC previously interpreted the Treasury Amendment to preserve CFTC jurisdiction whenever the enumerated financial instruments were offered to the public).

voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest of participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to purchase any of the foregoing.⁵⁰

The question of what constitutes a security has baffled scholars and courts alike for over half a century. In 1946, the Supreme Court fashioned the benchmark test in *SEC v. W.J. Howey Co.*⁵¹ In *Howey*, the owner of a citrus grove offered half of its acreage to the public to finance further growth of its company. The owner coupled its offer of the land sales contract with an option to enter into a service contract which conferred full management rights to the property to the owner. Since most offerees were investors not schooled in the nuances of citrus growing, eighty-five percent of those investing bought into both contracts.⁵² In determining whether the offering qualified as a security, the court focused on four factors. First, a person must invest money in a contract, transaction, or scheme.⁵³ Second, the instrument must be part of a common enterprise.⁵⁴ Third, there must be an expectation of profits from the instrument.⁵⁵ Fourth, the expectation of profits must be derived solely from the efforts of the promoter or a third party.⁵⁶ In finding that the transaction qualified as an investment contract

50. Securities Act of 1933, § 2(1) (codified at 15 U.S.C. § 77(b)); Securities Exchange Act of 1934 § 3(10) (codified at 15 U.S.C. § 78(c) (1988)).

51. *Howey*, 328 U.S. 293 (1946).

52. *Id.* at 295-96.

53. *Id.*

54. *Id.* The Ninth Circuit later defined "common enterprise" as "one in which the fortunes of investors are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1972), *cert. denied*, 414 U.S. 821 (1973). See also *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (providing an early application of the 9th Circuit's test).

55. *Howey*, 328 U.S. at 299.

56. *Id.* at 300.

and therefore a security, the Court noted that individual development of the plots of land was infeasible.⁵⁷ Investors could not have purchased the plots for the purpose of cultivating them themselves, making the offering more than simply a sale of land. Rather, the offering essentially amounted to an investment opportunity whose success hinged on the managerial efforts of the grove owners.

Subsequent courts have found the *Howey* analysis relevant only to deciding whether an investment contract, which encompasses all instruments not specifically covered by Section 2(1), constitutes a security. In *Landreth Timber Co. v. Landreth*, the Court held that so long as a stock possesses all the characteristics traditionally associated with the term, it automatically qualifies as a security.⁵⁸ However, in *Reves v. Ernst & Young*,⁵⁹ the Court retreated to a *Howey*-like analysis in considering whether a note fell under the umbrella of Section 2(1). The Court began by presuming that all notes are securities.⁶⁰ Next, the Court compared the note in question to a list which the Second Circuit had concluded were not securities.⁶¹ Instruments bearing a close “family resemblance” to a listed note are not grouped per se as a security.

For notes which resemble nothing on the list, the Court moved to a four factor test. First, it considered the motivation of the buyer and seller in entering into the transaction. If the goal of the transaction is investment of money, rather than facilitation of a loan, a security exists.⁶² This prong

57. *Id.*

58. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 682 (1985).

59. *Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990). For an excellent analysis of the state of the law on whether a note constitutes a security, see Stephen J. Greenberg and Noel M. Gruber, *The Impact on Commercial Banking of Recent Developments in the Federal Securities Laws*, ALI BANKING AND COMMERCIAL LENDING LAW, Vol. XIII at 41 (1992).

60. *See Reves*, 494 U.S. at 56.

61. *Id.* This list includes “the note delivered in consumer financing, the note secured by a mortgage on a home, the short term note secured by a lien on a small business or some of its assets, the note evidencing a ‘character’ loan to a bank customer, short term notes secured by an assignment of accounts receivable, or a note which simply formalizes an ‘open account debt’ incurred in the ordinary course of business.” *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976). The Second Circuit did not extend the presumption that all notes are securities to notes maturing within a nine month period. Such notes are exempted from registration by Section 3(a)(3) of the 1933 Act, but are not immune from the antifraud provisions of the 1933 or 1934 Acts. *See also Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir. 1984) (adding to the list notes evidencing bank loans made for “current operations”); *Singer v. Livoti*, 741 F. Supp. 1040, 1049 (S.D.N.Y. 1990) (adding notes secured by home mortgages issued through a lawyer in a commercial lending transaction).

62. *Reves*, 494 U.S. at 63 (1990).

mimics the first element of the *Howey* test, namely, investment of money in a transaction or scheme. Second, the *Reves* Court examined the “‘plan of distribution’ of the instrument,”⁶³ which is akin to the “common enterprise” analysis of the *Howey* test. Third, the Court looked at whether the investing public reasonably expected the instrument to be classified as a security. Finally, the Court considered whether the existence of another form of regulation adequately protected investors, thereby rendering application of the 1933 Act unnecessary.⁶⁴

No court has decided whether a swap transaction constitutes a security. However, in *Chicago Mercantile Exchange (CME) v. SEC*,⁶⁵ the Seventh Circuit narrowed the jurisdiction of the SEC over instruments which possess elements of both commodities and securities. The court found that an index participation, which contained some but not all features of stock and some but not all characteristics of a futures contract, fell solely under the domain of the CFTC. Employing somewhat dubious reasoning, the court decided that although the instrument did not fit squarely either as a security or as a futures contract, deference to the agencies’ interpretation of their own statutes permits classification of the instrument as both a commodity and a security.⁶⁶ In other words, so long as an instrument possesses at least one element of a commodity, the court will permit the CFTC to classify the instrument as a commodity for the purposes of regulation. Similarly, so long as an instrument possesses at least one element of a security, the court will not overturn an SEC pronouncement that the instrument is a security. This reasoning clashes with the body of case law on what constitutes a security. Courts consistently find that instruments, though possessing some characteristics of securities, do not qualify as such despite the contentions of the SEC to the contrary. Rather, courts hold that instruments must have a close nexus to another instrument already considered to be a security⁶⁷ or to an instrument named in Sections 2(1) and 3(10).

The effect of *CME v. SEC* is to give the regulatory bodies ultimate say over how to regulate new financial instruments. But at the same time, the decision deals the CFTC the crucial upper hand. *CME v. SEC* interprets the

63. *Id.*

64. *Id.*; see also *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (holding that a government insured certificate of deposit was not a security since federal banking laws protect such investments).

65. *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989).

66. *Id.* at 547, 549.

67. *Landreth*, 471 U.S. 681.

exclusivity clause of Section 2(a)(1)(A) of the CEA to arm the CFTC with sole jurisdiction over an instrument which is classified as both a commodity and a security.⁶⁸ But Section 2(a)(1)(A) also claims not to limit any other regulatory body from properly asserting its jurisdiction over an instrument.⁶⁹ Under the latter clause of Section 2(a)(1)(A), it could be argued that despite the exclusivity clause, the CEA permits the SEC to regulate instruments which fit both as a commodity and a security.

CME v. SEC provides the CFTC with the first crack at regulating all new instruments with aspects of both futures contracts and securities.⁷⁰ If the CFTC passes on its regulatory authority, it is unclear whether the SEC may then act. While the effect of *CME v. SEC* seemingly is to bar the SEC from asserting any jurisdiction over instruments which may not qualify precisely as futures contracts but possess some elements of both futures contracts and securities, the reasoning of the Seventh Circuit has come under attack,⁷¹ and may not be upheld if the SEC tests the waters by attempting to assert jurisdiction over swap transactions.

III. THE CURRENT STATE OF REGULATION

A. *The CFTC Abdicates the Throne*

CME v. SEC potentially could wield a profound impact on the regulation of swap transactions. Swaps possess characteristics of both commodities and securities. In broad terms, a swap is a contract involving a stream of payments to be made in the future, and as such resembles a futures contract.⁷² Let us consider swap transactions in light of the CFTC definition of futures contracts. First, in an interest rate swap, the parties do not transfer the underlying commodity, in this case the principal of the loan. In fact, neither party makes any principal payments during the life of the transaction.⁷³ The payments made constitute amounts fixed by the transaction based on a mathematical formula. No exchanges of interest or

68. *Chicago Mercantile Exchange*, 883 F.2d 537.

69. *See* 7 U.S.C. § 2 (1988).

70. *Chicago Mercantile Exchange*, 883 F.2d 537; *see* Russo & Vinciguerra, *supra* note 38, at 1437.

71. *See, e.g.*, Russo & Vinciguerra, *supra* note 38.

72. Hu, *supra* note 18, at 347.

73. *Id.*

principal occur. In a currency swap, however, both interest and principal are transferred.⁷⁴ The transaction seeks to exchange the commodities, namely the currencies transacted, for each other. In a sense, however, this is a misnomer. The effect of a currency swap parallels that of a forward contract or futures contract in foreign currency, to transfer price risk of the currency. Second, when employed as a hedging device, both interest rate and currency swaps undertake to shift price risk. Since the chief aim of the CFTC is to regulate hedging activities,⁷⁵ swaps fall securely within this realm. Third, swaps contain none of the distinctive qualities of a futures contract. Standardized units, margin requirements, centralized trading and public price quotations are absent in current swap transactions. Swaps conducted through dealers resemble clearinghouse transactions to the extent that by the terms of the particular contract, the dealer guarantees performance of the swap. Thus, unlike futures contracts, swap customers need not fulfill statutory margin requirements and no regulatory regime insures the transactions themselves. Although swap transactions fail to measure up to most of the elements of a futures contract, the Congressional declaration of the CFTC as the guardian of transactions which serve as a hedging device, coupled with the CFTC paradigm of wide agency discretion, provides enough of an aperture to qualify the instruments as futures contracts.⁷⁶ As mentioned, under current law, classification as a futures contract arms the CFTC with exclusive jurisdiction over the instrument under Section 2(a)(1)(A) of the CEA.

Congress moved to provide legal certainty as to the proper regulatory treatment of swaps by passing the Futures Trading Practices Act of 1992 (FTPA).⁷⁷ Section 502 of the FTPA amends Section 4 of the CEA to permit the CFTC to exempt any agreement, contract, or transaction which

74. *Id.* at 353.

75. When Congress created the CFTC in 1974, it intended for the CFTC to "regulate markets and instruments that serve a hedging and price discovery function and [for] the SEC [to] regulate markets and instruments with an underlying investment purpose." S. REP. NO. 384, 97th Cong., 2d Sess. 22 (1982). "One could think of the difference between the jurisdiction of the SEC and the CFTC as the difference between capital formation and hedging. Congress conceived of the role of the CFTC when it created the agency." *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 543 (1989).

76. See S. REP. NO. 384, *supra* note 75.

77. 7 U.S.C. § 6(a) (1992). For a summary of the FTPA exemptions and a comparison with past CFTC regulation of swaps, see David S. Mitchell and Mark W. Saks, *CFTC Exemptions for Swap Agreements and Hybrid Instruments*, in 9 REV. OF BANKING & FIN. SERVICES 87 (Standard & Poor's, May 5, 1993).

otherwise qualifies as a futures contract from the requirement that such an instrument be traded on an organized futures exchange. More importantly, the Amendment grants the CFTC the power to declare such an instrument immune from any other provision of the CEA, with the key exception of Section 2(a)(1)(B), which confers exclusive jurisdiction of all futures contracts upon the CFTC.⁷⁸

In order to exempt such a transaction, the CFTC must make three findings. First, the Commission must decide that the public interest supports such an exemption.⁷⁹ Second, the CFTC must find that the transaction will not impede the Commission and exchanges under its jurisdiction from performing their regulatory duties under the CEA.⁸⁰ Third, the CFTC must be satisfied that the transaction involves solely “appropriate persons” as parties.⁸¹

The FTPA defines appropriate persons to encompass parties reasonably likely to guarantee the obligations of the transaction—in other words, parties who seemingly do not require an independent clearinghouse to insure the transaction.⁸² One such group consists of financial institutions, including banks or trust companies, savings associations, insurance companies, and investment companies coming under the Investment Company Act of 1940. Presumably, such institutions possess the capital reserves to guarantee the transaction and are regulated by other regimes. Another group contains commodity pools, futures commission merchants (FCM’s), floor brokers and floor traders subject to CFTC regulation under the CEA, and broker-dealers subject to SEC regulation under the 1934 Act. Since these parties already fall under the umbrella of the CFTC or the SEC, presumably these agencies will discover spurious transactions before they occur. For the most part, the members of the latter group do not have the resources to conduct a swap and are not in the business of attempting to do so.

The third group of “appropriate persons” is composed of corporations or other business entities with a net worth in excess of \$1 million, total

78. Mitchell and Saks, *supra* note 77.

79. *Id.*

80. *Id.*

81. *Id.*

82. The legislative history of the FTPA indicates that appropriate persons have been so designated because the CFTC determined that such entities “have the financial and other qualifications adequate to fulfill the terms and conditions of the agreement.” S. REP. NO. 22, 102d Cong., 1st Sess. 60 (1991).

assets over \$5 million, or which by terms of the agreement guarantee the obligations of the transaction, and employee benefit plans with assets of more than \$1 million or whose investment decisions are made by a party represented in one of the first two groups. Again, the Act aimed to ensure that participants in unregulated transactions possess the reserves to guarantee the obligations of the contract. However, with regard to swap transactions, the restrictions on this cluster are meaningless. The magnitude of most swaps presently conducted dictates that only parties with capital well in excess of the minimums will dare to delve into such dealings. Further, the exposure of swappers who default on their payments dwarfs the minimum capital requirements which the Act imposes and thus serves as a flimsy barrier to parties who overextend themselves in swap transactions. Such overexposure is not unlikely, since corporate decision-makers understand the risk of swaps to an even lesser degree than their counterparts in the banking industry,⁸³ and unwarily could authorize a swap which far outstrips the company's financial ability to fulfill its obligations under adverse market contingencies. Ill-conceived swaps could result in overexposure so catastrophic as to bankrupt the company and force it to incur obligations it can never repay. Finally, the amendment authorizes the CFTC to designate other persons who may conduct swap transactions under the exemption. To this end, the CFTC has adopted Rule 35.1(b)(2)(xi), which allows persons (including individuals) to conduct unregulated swaps provided their net worth exceeds \$5 million or their total assets surpass \$10 million.⁸⁴

The CFTC imposed three additional criteria which parties to swap transactions seeking immunity from the CEA must satisfy. First, swaps may not be part of a "fungible class of agreements that are standardized as to their material economic terms."⁸⁵ This requirement aims to prevent the exemption from covering standardized swap contracts.⁸⁶ If a market for boilerplate swaps develops, the CFTC wishes to retain jurisdiction under the CEA.

83. See Patrick Haverson, *Survey of Derivatives*, FIN. TIMES, Dec. 8, 1992, at II.

84. CFTC Proposed Rules: Exemption for Certain Swap Arrangements, 54 Fed. Reg. 53,627 (1992) [hereinafter CFTC Rules]; 17 C.F.R. § 35.1(b)(2)(xi) (1992); A. Robert Pietrzak & Michael S. Sackheim, *CFTC Exemption Procedures for Novel Derivative Transactions*, in 26 REV. OF SEC. & COMMODITIES REG. 121 (Standard & Poor's, 1993) (codifying the adopted rule).

85. Pietrzak & Sackheim, *supra* note 84, at 123.

86. *Id.*

Second, the creditworthiness of parties obligated to the swap must receive "material consideration"⁸⁷ in defining the terms of the agreement. The CFTC aims to exclude transactions subject to a clearing mechanism, which shifts the credit risk away from the obligated parties and instead installs a system of mutualized risk of loss which binds members regardless of whether they are parties to the original transaction.⁸⁸ The rule seeks to ensure that exempted swaps remain distinct from futures contracts in that no clearinghouse guarantees the obligations of swap participants. Ease of administration may play a central role behind this requirement. The CFTC can be forced to regulate any clearinghouse for swap transactions, or at least enumerate specific conditions for its exemptions. By prohibiting swap transaction clearinghouses, the CFTC relieves itself of this burden. The Commission believes that the capital requirements for exempt swap participants provided in the FTPA suffice to enable the parties to clear their own transactions, and that such parties possess the financial resources or expertise to evaluate the credit risk of their counterparts. As such, a guaranteed clearinghouse confers only marginal benefits.⁸⁹

Here, it is important to reiterate that absent a contractual provision to the contrary, a customer whose swap partner defaults on the transaction holds no warranty for performance. Most customers swap with large lending institutions which by federal law must boast sizable capital reserves. These reserves are calculated in a manner designed to ensure that they are sufficient to back every swap transaction the institution undertakes.⁹⁰ The wave of bank failures during the past decade highlighted one danger of

87. *Id.* at 124.

88. CFTC Rules, *supra* note 84.

89. *Id.* In August 1993, CFTC officials convened with industry leaders and discussed the possibility of developing a central clearing facility for swap transactions. *CFTC Swaps Clearinghouse Discussion Sparks Debate Among Exchanges*, 25 Sec. Reg. & L. Rep. (BNA) 1136 (Aug. 13, 1993). Proponents maintain that a swaps clearinghouse would decrease the costs of conducting swaps while managing risk. Further, a clearinghouse would prevent less credit worthy parties from being shut out of the swap market. *Id.* The idea is that in the absence of a clearing facility, parties with high credit ratings typically would not wish to conduct swaps with parties having a lesser credit rating, since the latter have a higher probability of default. Private incentives dictate, however, that parties with differing credit ratings could still match on a swap transaction without a central clearing facility. The party with a higher rating could command a premium for entering into the transaction with a less credit worthy party since the former accepts a greater level of default risk. Opponents argue that the customized nature of swaps, the inability of a clearinghouse to predict volatility in order to measure risk, and "phenomenal" start-up costs constitute formidable impediments to the formation of a swap clearinghouse. *Id.*

90. See discussion *infra* part III.C.

leaving the swap market unregulated.⁹¹ However, since the capital requirements of banks are regulated,⁹² the risk of default on swap transactions only exceeds the risk of default on a traditional extension of credit (e.g., a consumer loan) if each of two conditions are met. First, banks must misinterpret the risks of the swap. When extending traditional credit, the bank charges a premium based on its evaluation of the risk of the customer defaulting on the loan. The bank, seeking to maximize its return, will extend credit (to the extent that such business is available) to the equilibrium point where its default risk meets its legally imposed minimum capital requirement. Stressing the increasing complexity of today's swaps, many contend that nobody, least of all the bankers, can quantify the risks inherent in swaps.⁹³ If bankers underestimate the risks of their swaps, the probability of customer default exceeds the default premium. Thus, the default risk calculus will be skewed, and the bank will attempt to assume more risk from swap transactions than the true optimal level. In reality,

91. Fears of bank failure may not be completely unfounded, even in the current climate of high profitability in the banking industry. Derivative activity does not appear on a bank's balance sheet, which can render its financial statements misleading. An efficient market discounts from the financials when valuing the bank's stock to account for the risk of an adverse shock to the bank's swap portfolio. A severe enough shock could threaten the viability of the bank. Banc One Chairman John B. McCoy claims that the extensive use of interest rate swaps contributed to a decline in Banc One's share price. Steve Klinkerman, *Banc One's McCoy Tries to Calm Fears Over Heavy Use of Derivatives*, AM. BANKER, Oct. 22, 1993, at 4. Banc One maintains \$31 billion of off-balance sheet interest rate swaps, compared with \$75 billion in other assets, a ratio which likely is not atypical of major commercial banks. *Id.* While a default on all of its swaps would not jeopardize its viability on the books, clearly it would place Banc One in a serious financial pinch.

Notably, however, the use of swaps has added to the bank's profitability. Some industry leaders have lauded Banc One for its prudent risk management strategy and feel that the correction in share price due to derivative activity is temporary. Steven Lipin, *Banc One Draws Interest of Investors*, WALL ST. J., Dec. 10, 1993, at C1.

92. *E.g.*, FDICIA § 131, 12 U.S.C. § 1831 (Supp. III 1991); Proposed [Federal Reserve Board] Rule to Incorporate Credit Risks on Interest Rate Swaps Into Proposed Risk-Based Capital Measure, 52 Fed. Reg. 9304 (Mar. 24, 1987); *see generally* 12 C.F.R. Part 225 (1993).

93. For an explanation of why banks invariably misinterpret the risks of their swaps, see Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1467-70 (1993). Hu does maintain that bankers at least edge regulators in the race to comprehend derivative product risk. *Id.* at 1463.

Conversely, Joseph P. Bauman, Chairman of the International Swap Dealers Association (ISDA) and head of derivatives at Citibank, claims that current risk management facilities adequately account for the risk of swaps. Bauman stresses that swap risk differs little from other risks which financial institutions undertake in the ordinary course of their business. Further, both the innovators of the instruments and regulators sufficiently understand the risk to uphold the current regulatory paradigm safely. Claudia Cummins, *Q and A: Swaps Industry Is Self-Regulating, Chairman Says*, AM. BANKER, Oct. 28, 1993, at 3.

banks have economic incentives to overweigh, rather than underweigh, the extent of their risk. Banks recognize that the true risk level of swaps is unquantifiable. Fearing the potentially disastrous consequences of overexposure on their financial viability, banks will err on the side of underweighing the true risk levels.⁹⁴ Thus, if banks act rationally, the danger of default on swap transactions may not be cause for alarm, even if managers misinterpret the risk of swap transactions. Second, the legally imposed minimum capital requirements must misconstrue the risk factors. If the minimum requirements properly evaluate the risk, even if the bank attempts to overextend itself, the requirements will act as a check and will prohibit the bank from engaging in more swaps than the true optimal level. But, as the discussion in Part III.C. of this note indicates, the requirements fail to consider all relevant risk factors and, as a result, will yield skewed capital requirements. The solution to this problem is not added regulation, but correction of the minimum capital requirement formulae to reflect the true risk factors.

The third CFTC criterion for CEA immunity is that the swap-traders must not trade on or through an organized market.⁹⁵ Since a central characteristic of a futures contract is that it must trade on a CFTC-authorized exchange, in the absence of the exemption, under *CME v. CFTC*; the CFTC would likely be empowered with regulating any central market for swaps. Such markets would be required to fulfill the conditions of section 5 of the CEA. While presently no centralized swap market exists,⁹⁶ exchanges worldwide have been mixing ingredients in attempts to conjure the ideal potion for the prize swap contract that will capture the huge transaction fees for arranging swaps from private investment firms.⁹⁷

94. The response is that if banks operate completely in the dark with regard to swap risks, they never can be sure that they are underweighting true risk levels, no matter how few swaps they conduct.

95. Pietrzak & Sackheim, *supra* note 84, at 124. section 35.2(d) mandates that a swap must not trade through a "multilateral execution facility," which essentially entails an organized market, such as a futures exchange. The CFTC defines "multilateral execution facility" as "a physical or electronic facility in which all market makers and other participants have the ability to effectuate transactions and bind both parties by accepting offers which are made by one member and open to all members of the facility." CFTC Rules, *supra* note 84. The prohibition does not prevent counterparties from utilizing information transmittal or other electronic facilities so long as the parties privately negotiate a bilateral transaction and do not use the system to place orders to execute the transaction. 17 C.F.R. § 35.2(d) (1992).

96. At least to the knowledge of the CFTC, no such market exists.

97. The CBT first attempted to trade two interest rate swap futures contracts in 1991. The effort failed largely because the ISDA rebuffed the contracts. Currently, the CBT plans to establish a trading

Exchange-traded contracts can offer liquidity, public price disclosure, and clearinghouse guarantees. However, unless an exchange could craft a contract which retains customization, most likely few major swap players would be interested.⁹⁸ The effect of the CFTC rules is to exempt all interest rate swap transactions conducted on the over-the-counter market. However, the CFTC retains regulatory power over swaps traded at exchanges such as the CBT and CME.⁹⁹ The final CFTC rules leave open the possibility that the CFTC can enforce its antifraud provisions with regard to swaps.¹⁰⁰ In its comments to the final rules, the CFTC noted that “[t]o the extent that swap agreements may be deemed subject to the [Commodity Exchange] Act, the Commission has determined specifically to reserve in these rules the antifraud authority applicable to futures contracts and options transactions.”¹⁰¹

B. The SEC: The Legal Heir?

The SEC has yet to decide formally whether it should add swap transactions to its potpourri of regulated instruments.¹⁰² In order to fall under the SEC’s reign, swaps must qualify as securities under the definition

system called HITS (Hybrid Instruments Transactions System) which will facilitate the purchase and sale of interest rate swaps and an array of other novel instruments on a computerized trading market. William B. Crawford, Jr., *Board of Trade Maps New Foray Over the Counter*, CHI. TRIB., Jan. 14, 1993, § 3, at 1. For a discussion of computerized futures trading at major exchanges, see Michael B. Sundel & Lystra G. Blake, *Good Concept, Bad Executions: The Regulation and Self-Regulation of Automated Trading Systems in United States Futures Markets*, 85 NW. U. L. REV. 748 (1991).

98. See Caren Chesler, *Executive Update*, INVESTOR’S DAILY, Dec. 31, 1992, at 3 (noting that although exchange-traded swaps are in the works, inability to customize may doom such contracts). *But see* Morse, *supra* note 8, at IV (quoting Chicago Board Options Exchange Vice-Chairman William Floersch who noted that organized exchanges plan to court the “small and medium sized dealers into the derivatives business”). Presumably, the exchanges believe that the burgeoning demand for swap products is sufficient to support futures contracts for the instruments, and that the smaller players will supply a sufficient niche for exchange contracts.

99. William B. Crawford, Jr., *CFTC Says Swaps Market Is Out of Its Jurisdiction*, CHI. TRIB., Jan. 15, 1993, § 3, at 3; Sandra Block, *CFTC to Exempt Most Swaps From Its Rules*, WALL ST. J., Jan. 15, 1993, at A5.

100. *‘Swaps’ Market Won’t Face Regulation, But Rules Against Fraud, Manipulation Will Apply*, ATLANTA J. & CONST., Jan. 15, 1993, at G5.

101. *CFTC Adopts Final Rules Exempting Swaps and Hybrids*, 60 BANKING REP. (BNA) 93 (Jan. 25, 1993), available in Westlaw, BNA-BNK Database.

102. The SEC indicated that it would assert jurisdiction in the event that a broker-dealer defrauded an unsophisticated investor in a swap transaction. *House Hearing, supra* note 1. “[The SEC] will not hesitate to enforce the antifraud provisions of the [1933 and 1934 Acts] . . . to ensure that broker-dealers refrain from recommending unsuitable [derivative] products to uninformed investors.” *Id.*

in sections 2(1) and 3(10) and its progeny of case law. Under the *Reves* analysis,¹⁰³ even if a swap transaction properly can be classified as a note, most likely it will fail to rank among the notes which constitute securities.¹⁰⁴ Swaps resemble notes in two primary ways. First, both involve a stream of payments to be made over a period of time. Second, financial institutions play central roles in both types of transactions. Large banking institutions in the ordinary course of their business act as dealers to the swap transaction, while lending institutions are in the business of issuing notes for various loans. Unlike the notes classified as investment vehicles, and therefore securities under the *Reves* analysis, swaps do not purport to be notes and have many features which distinguish them from the prototype note. Most significantly, unlike a note, which typically involves a lump sum payment by the lender and a series of repayments by the borrower, a swap entails a “trade” of note-like obligations which require both parties to make a stream of payments throughout the life of the swap. Further, unlike traditional notes, swaps entail no exchange of principal.

Applying the *Reves* test, swaps clearly bear no “family resemblance” to any note on the Second Circuit’s list of notes which are not securities. Defaulting to the four part test,¹⁰⁵ first, hedging against price risk or gaining access to otherwise unavailable sources of capital motivate the entrant into the swap. Such a goal fails to evince investment intent if the term “investment” is defined as allocation of money with the expectation of obtaining an income or profit.¹⁰⁶ When used as a hedging device, the swap offers no rate of return, income, or profit; it functions merely as a shield to price fluctuations. When employed to access unavailable capital, the swap serves to facilitate a loan, a function which the *Reves* court specifically cited as signaling an absence of investment intent.¹⁰⁷ Second, swaps typically constitute specific bargains between the two parties and as such, no “plan of distribution” or “common enterprise” exists. The dealer

103. See *supra* notes 59-64 and accompanying text.

104. A swap does not clearly resemble any other instrument named in Section 2(1) and 3(10). If a swap was not considered a note, and thus resembled no stated instrument, the analysis would proceed to determining whether a swap qualified as an investment contract under the *Howey* test. Under this analysis, the swap would fail the first two elements of the test. See *supra* notes 51-57 and accompanying text. Third, no expectation of profits exist; the parties expect merely to hedge risk or access new capital. Since no profits accrue, the fourth factor is inapplicable and need not be considered.

105. See *supra* text accompanying notes 51-56.

106. See, e.g., WEBSTER’S NEW INTERNATIONAL DICTIONARY (3rd Unabridged Edition 1981).

107. See *supra* note 62 and accompanying text.

offers the particular swap only to an individual customer, not to any group of entities, and the customer and the dealer are the sole parties to the agreement. Third, the sophistication of all parties entering into swap transactions creates the presumption that such parties know that the SEC does not regulate the instruments as securities. Since swaps do not involve any offerings to persons not party to the transaction, whether or not the general investor perceives swaps as securities is irrelevant. Finally, the CFTC possesses primary jurisdiction over swap transactions given that they are classified properly as futures contracts. Any jurisdiction the SEC chooses to assert would be subject to CFTC challenge under the exclusivity clause of the CEA. Besides creating additional friction between the two agencies, the plain language of the CEA and the interpretation of the Seventh Circuit in *CME v. SEC* indicate that the CFTC solely controls instruments which are both commodities and securities.¹⁰⁸

C. Alternative Regulatory Regimes: Famine or Buffet?

1. A Dish of International Self-Regulation: The BIS Accord

Banking institutions worldwide face billions of dollars of exposure to loss from derivative products, with ninety percent of this risk accrued in seven institutions.¹⁰⁹ When compared to the size of the \$3.5 trillion banking system,¹¹⁰ the concentration of risk in many of the world's largest institutions could be cause for alarm. Since the major risk of institutions entering into swap transactions is what Federal Reserve Vice-Chairman David Mullins, Jr. terms "old-fashioned credit exposure,"¹¹¹ the failure of any one of these institutions could have a domino effect on the entire industry, which in turn would cause an odor of doom to waft throughout the global financial community.¹¹² The impact on the global economy would be drastic—equivalent to the detonation of an economic time bomb. As a preemptive strike against such a catastrophe, financial leaders from the

108. See *supra* note 66 and accompanying text.

109. David Mullins, Jr., Vice-Chairman, Federal Reserve Board, Address at the JFK School of Government, Harvard University (C-SPAN television broadcast, Dec. 17, 1992).

110. *Id.*

111. *Id.*

112. See *infra* note 141 and accompanying text.

major global financial powerhouses convened to develop a risk control mechanism for these institutions.

In 1988, the Basle Committee on Banking Regulations and Supervisory Practices of the Bank of International Settlements (BIS) established a complex set of rules designed to set a consistent international standard for capital supply for all international banks.¹¹³ The Federal Reserve adopted the BIS rules for minimum capital requirements in 1989, and today these rules govern all domestic banks.¹¹⁴ These rules require banks to maintain capital reserves sufficient to guarantee performance on their swap transactions.¹¹⁵ Banks must meet specified capital adequacy ratios, which measure the bank's ratio of capital to its aggregate credit risk. Intricate formulae determine the amount of credit risk an institution undertakes. Each swap transaction the bank enters is funneled into the formula.¹¹⁶ The formula yields an adjusted figure representing the total assets of the bank to account for overall risk exposure of the institution occasioned by its swap transactions.¹¹⁷ Under rules which took effect at the end of 1992, banks must support the capital equivalent of eight percent of their risk-adjusted assets.¹¹⁸

If the calculations under the BIS formulae could produce perfectly accurate figures, the BIS Accord would effectively address the problem of default. If banks could in fact back the performance of all swap transactions, thus performing the role of a clearinghouse, the swap consumer would be protected in much the same manner as the futures contract customer who retains the benefit of CFTC protection. However, one major flaw infests the BIS Accord. The BIS engineers developed the formulae for calculation of risk factors to evaluate the traditional swap contracts popular at the time.¹¹⁹ The past several years have witnessed a spiraling in the

113. *BIS Committee Amends Capital Rules to Further Define Loan Loss Reserves*, 56 BANKING REP. (BNA) 369 (Feb. 21, 1991) [hereinafter *BIS Amendment*]. For an in-depth discussion of the history of the BIS committee and an analysis of its 1988 accord, see Hu, *supra* note 18, at parts II-III. See also Camille M. Caesar, *Capital-Based Regulation and U.S. Banking Reform*, 101 YALE L.J. 1525 (1992); Duncan E. Alford, *Basle Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry*, 10 DICK. J. INT'L L. 189 (1992).

114. Caesar, *supra* note 113, at 1526; 12 C.F.R. § 208.1-127 & app. A-B (1991); 12 C.F.R. § 160-88 & app. A-B, 208 1-127 & app. A-B (1991).

115. Hu, *supra* note 18, at 371.

116. *Id.* at 386.

117. *Id.* at 392.

118. *BIS Amendment*, *supra* note 113, at 369.

119. Hu, *supra* note 18, at 413.

complexity of swap transactions. Since the accuracy of the numbers diminishes as the swap becomes more complex, applying the formulae to today's swaps results in capital requirements which bear little if any relation to the true risk factors.¹²⁰ Further, the BIS formulae primarily measure credit risk, and effectively ignore interest rate risk.¹²¹ Credit risk is the risk of a counterparty to a swap transaction defaulting on its payments.¹²² Interest rate risk is the risk that fluctuations in interest rates will hurt the financial condition of the bank.¹²³ Such risk occurs when dealers possess an unbalanced portfolio of swap transactions. A dealer who has sold significantly more swaps to customers with variable rate liabilities and fixed rate assets than to customers with the opposite asset-liability mix encounters interest rate risk. Since interest rate risk is not factored into the BIS formulae, banks have no formal incentive to mitigate interest rate risk. Given the likely possibility that the bank has an unbalanced swap portfolio,¹²⁴ the formulae will yield skewed capital requirements.

Due to the inevitable inaccuracy of its capital requirements, the BIS Accord offers little guarantee of the liquidity of swap dealers. Further, even if the agreement did eradicate all risk of default, and did consider interest rate risk, its existence would not obviate the need for further regulation. The BIS Accord regulates only the banking institutions which conduct swap transactions. It does not regulate the swap transactions themselves, nor does it contain any provisions to guard against fraud.

2. *The FDICIA Grabs a Plate*

To supplement one void left by the BIS Accord, the Federal Deposit Insurance Corporation Improvement Act added measures to address interest

120. *Id.* at 415. For a more general critique of the BIS Accord, see Kenneth J. Gordon, *Risk-Based Capital Requirements: The Proper Approach to Safe and Sound Banking?* 10 ANN. REV. BANKING L. 491 (1991).

121. *See* Prop. Treas. Reg., 57 Fed. Reg. 35,507 (1992) (Risk-Based Capital Standards).

122. Haverson, *supra* note 83, at II.

123. *Fed Adopts Notice on Interest-Rate Risk, Proposes Prompt Corrective Rules*, 58 BANKING REP. (BNA) 1120, 1120 (June 29, 1992) [hereinafter *Fed Notice*].

124. *See* Klinkerman, *supra* note 91 at 4. "Banc One is typical of most banks . . . in that it has a heavy concentration of variable-rate loans and fixed-rate deposits that leaves it in a position where assets perennially are repricing more quickly than liabilities. This is precarious in an environment of falling rates." *Id.*

rate risk in computing capital maintenance standards.¹²⁵ Section 305 of the FDICIA¹²⁶ mandates federal banking agencies to revise their risk-based capital standards to ensure appropriate consideration of the risk of nontraditional banking activities such as interest rate swaps.¹²⁷ Institutions judged to possess excessive levels of interest rate risk would be forced to hold additional capital in an amount proportionate to the added risk.¹²⁸ The FDICIA developed a sophisticated model to evaluate interest rate risk. The paradigm incorporates into its calculations complex financial instruments such as the swap transactions that currently prevail.¹²⁹ While the FDICIA addresses one failure of the BIS Accord, namely accounting for interest rate risk in its calculations, it fails to remedy the defects in the existing system of determining credit risk. The Federal Reserve has not yet crafted revised risk-based formulae to account for credit risk which adequately consider the complexity of current swap transactions, although it is currently taking comments on how best to revise the existing standards.¹³⁰

The Treasury Department announced three principal objectives in adopting capital requirements which account for interest rate risk. The first objective is “to make capital requirements sensitive to differences in interest rate exposures among savings associations. . . .”¹³¹ The second goal is to “discourage savings associations from taking excessive interest rate risk by making such behavior more costly. . . .”¹³² The third aim is to “ensure that adequate capital is maintained in savings associations to reduce the exposure of the deposit insurance fund and to protect the taxpayers’ interests.”¹³³ As the objectives of the FDICIA indicate, the Act is solely concerned with protecting depository institutions. Regulation of swap transactions themselves, and protection of the customer who engages in

125. Prop. Treas. Reg., 57 Fed. Reg. 35, 507 (1992) (Risk-Based Capital Standards).

126. FDICIA § 305, 12 U.S.C. §1828 (Supp. III 1991).

127. For a detailed analysis of the formulae which calculate interest rate risk, see Prop. Treas. Reg., 57 Fed. Reg. 40,524 (1992) (Regulatory Capital: Interest Rate Risk Component) [hereinafter Treasury Rules]; Prop. Treas. Reg. 48,206 (1993) (Risk-Based Capital Standards: Interest Rate Risk) (for a revision of the 1992 standard).

128. *Fed Notice*, *supra* note 123.

129. Treasury Rules, *supra* note 127, at 40,525.

130. *Fed Notice*, *supra* note 123. Existing standards for assessing credit risk are based on the BIS Accord guidelines. See Hu, *supra* note 18, at 366.

131. *Fed Notice*, *supra* note 123.

132. See *id.*

133. See *supra* note 95.

swaps, is outside the scope of the bodies who regulate the banking industry. Further, lawmakers question whether the FDICIA formulae accurately assess the degree of risk inherent in derivative product transactions.¹³⁴ The consensus both among industry leaders and regulators is that no one—not even the creators of the instrument—can evaluate the true extent of the risk.¹³⁵ Federal Reserve Board Governor John Le Ware noted that in light of the uncertainty surrounding these instruments, the Federal Reserve and the FDIC concurred early in 1992 that investment in derivative products, including swap transactions, is unacceptable for depository institutions.¹³⁶ In light of the enormous amount of funds banking institutions currently commit to swap transactions, any attempt to prevent banks from competing in the swap market would meet with considerable resistance, and therefore would never seriously be pursued.

3. SEC Risk-Assessment Rules: A Course for Nonbanking Swap Dealers

Finally, the SEC has leapt into the fray, adding its own appetizer to the regulatory potpourri. Rules 17h-1T and 17h-2T of the 1934 Act require broker-dealers (who by definition include only nonbank entities)¹³⁷ to adhere to specific recordkeeping requirements, which include disclosure and reporting to the SEC of the broker-dealers risk management policy, as well as certain financial data.¹³⁸ The goals behind these rules parallel those of the FDICIA—to assess the risks facing broker-dealers, including the risk of swap transactions, and to help the SEC handle the failure of a large investment firm in a manner that will minimize the impact on the global

134. *Fed Notice, supra* note 123.

135. *See supra* note 93.

136. *Id.*

137. “The term ‘broker’ means any person engaged in the business of effecting transactions in securities for the account of others, but *does not include a bank.*” Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(4) (1988) (emphasis added). “The term ‘dealer’ means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but *does not include a bank*, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.” Securities Exchange Act of 1934, 15 U.S.C. § 3(a)(5) (1988) (emphasis added). For further discussion of the relevant characteristics regarding who constitutes brokers and dealers, see Thomas A. Russo & Joyce P. Farnsworth, *Regulation of Equity Derivatives*, in *SWAPS AND OTHER DERIVATIVES IN 1992*, *supra* note 15, at 165, 203-06.

138. SEC Final Temporary Risk Assessment Rules, 17 C.F.R. § 240, 249 (1992).

financial system.¹³⁹ In practice, the SEC rules seek to offer similar guarantees of capital strength for institutions which the FDICIA does not govern (e.g., investment banks).

The SEC rules do not intend to regulate swap transactions in any form; they merely require large investment firms to disclose their swap positions on a quarterly basis.¹⁴⁰ The SEC plans to monitor the exposure of broker-dealers carrying an excess of \$20 million in capital to excessive interest rate and credit risk. Presumably, if the risk level surpasses a threshold level of materiality, the SEC will take measures to force the firm to return to an acceptable level of risk exposure. Fearing a repeat of the Drexel fiasco, the SEC is attempting to inhibit the largest financial institutions from leveraging themselves to such a degree that breaks in the market threaten their viability.¹⁴¹ Experts worry that the failure of such institutions would reverberate throughout the world economy and could create grave repercussions within the global financial community.¹⁴²

The SEC is currently considering modification of the Net Capital Rule to better account for the risks of new financial instruments, including swap transactions.¹⁴³ Comments from industry leaders are not expected until the end of 1993, meaning that final SEC action is unlikely until at least early 1994.¹⁴⁴

4. *The Barren Cornucopia: A Summary of the Present State of Regulation*

The issue of which regulatory body possesses jurisdiction over swap transactions has not been resolved. *CME v. SEC* indicates that the CFTC may possess exclusive jurisdiction, but so far that agency has refused to proclaim firmly that swaps qualify as futures contracts and thus fall squarely within its domain. Congress has taken an affirmative step by passing the FTPA, which when coupled with subsequent CFTC rules, fully exempts swap transactions not traded on organized exchanges from all provisions of

139. *New SEC Rules for Brokers' Affiliates Aim to Avoid Repeat of Drexel Problems*, [July-Dec] Banking Rep. (BNA) No. 59 at 96 (July 20, 1992) [hereinafter *Drexel Problems*].

140. 17 C.F.R. § 240.17h-1T(a1)(vii) (1992).

141. *Drexel Problems*, *supra* note 139.

142. SEC Proposed Rules: Net Capital Rules, 58 Fed. Reg. 27,486 (May 10, 1993).

143. *Id.*

144. *Derivatives Rule Stalled at the SEC*, AM. BANKER, Sept. 27, 1993, at 4.

the CEA and all CFTC regulation. The hands-off approach taken by the CFTC means that swap transactions are free from regulation. While the transactions themselves are unregulated, three bodies, each governing a different group of swap dealers, have penned complementary measures which seek to ensure that swap dealers maintain sufficient levels of capital to back their transactions and retain viability in a doomsday scenario. The BIS Committee, a self-regulatory body of international banks, implemented minimal capital requirements for banks acting as swap dealers, which reflect the credit risk banks incur in their swap transactions. The Federal Reserve adopted these capital requirements for domestic banks acting as swap dealers and added provisions which also account for interest rate risk. Finally, the SEC, which has refrained from formally claiming that swaps constitute securities (allowing it to assert jurisdiction over the instruments), adopted a rule requiring nonbank swap dealers which possess a certain level of capital to disclose and to report their swap transactions.

IV. A LOOK TO THE FUTURE

The unanimous consensus within the financial community is that the market for swap transactions and other derivative products will continue to mushroom and that the complexity of these instruments will continue to increase. As the notional amount of swap transactions grows, the ramifications of an adverse market reaction in an unregulated swap market become increasingly dangerous to the world economy. Further, as swap participants expand beyond institutional players, and become more widely accessible to smaller investors, the need for regulation becomes more pervasive. Little debate would occur if a more cost effective regulatory system existed that would mitigate the risks inherent in swap transactions and prevent a doomsday scenario. Unfortunately, no such system exists. The impossibility of obtaining perfect information about the risk of swap transactions means that any regulation based on risk factors will be flawed. However, all effective regulation need not measure risk factors. Antifraud provisions, for example, do not require perfect risk-based information to be effective. Further, even somewhat inaccurate risk-based regulation is desirable if it provides a benefit which exceeds its cost.

A. Costs of More Stringent Regulation

Adopting a more stringent domestic regulatory structure would impose two primary costs on swap transactions. First, regulating swaps imposes an internal cost on each swap transaction. In effect, regulation serves as a tax on swaps conducted in the United States. The exact impact of the tax depends on the nature of the regulation. Regardless of its nature, any regulation which forces the dealer to commit resources it would not otherwise commit imposes added costs on the dealer. In the absence of regulation, the rational dealer will expend resources on monitoring its risk until its marginal costs exceed its marginal benefits—the profit maximizing level of expenditures. If regulation demands that the dealer expend resources beyond this level, the cost to the dealer of conducting the swap transaction increases by the cost of the added burden of regulation. The difference between the expenditures in the absence of regulation and the expenditures under regulation constitutes the level of the tax.

Dealers will pass the the increased costs along to consumers in the form of higher premiums on swap transactions. Since swap transactions conducted abroad face no regulatory constraints, foreign swap dealers will possess a cost advantage in the swap market. Customers will shift their business away from U.S. dealers in order to take advantage of the lower premiums offered abroad. In addition, the lower profit margins caused by the regulatory tax would create disincentives to create new financial products. Since fostering innovative financial instruments is a priority of the CFTC,¹⁴⁵ further regulation would work against this end. Notably, coordinated global regulation of swaps would not create any of these ill effects. The tax of global regulation would be borne equally by all nations which conduct swaps. While the cost of conducting swaps may increase, all swap dealers will incur the cost equally. If regulation is truly optimal, consumers will not mind paying higher premiums in return for added insurance on their swaps. Thus, profit margins will be unaffected, and no added disincentives for innovation will be created.

The second cost of regulation is external; namely, the heightened cost to the agency that performs an additional regulatory function. If the agency has a fixed budget, the added regulatory burden of swaps will force the

145. See, e.g., Laurie Morse, *CFTC Confirmed as U.S. Futures Market Regulator*, FIN. TIMES, Oct. 8, 1992, at 29.

agency to divert resources away from some current uses. If the current uses confer more benefits than would employing the same funds to regulate swaps, an external cost results and regulation should not be pursued. Similarly, if the agency can procure additional funding to support swap regulation, abandoning the current structure either diverts resources from other government agencies or increases the tax burden on the public. Either way, someone bears additional costs. Again, in a paradigm of unified global regulation, such a problem disappears. Swap dealers, not governments, would fund the regulatory body. That agency would serve as a protective feature built into swap transactions. As such, if regulation were optimal, risk-averse consumers would be willing to pay more to receive the benefits of regulation.

B. Benefits of a More Stringent Regulatory Regime

In order for regulation to confer any benefits, it must provide a service which the current regulatory paradigm will not. This Note has mentioned two flaws with the current approach to swap regulation. First, neither private swap dealers nor the government agencies charged with setting minimum capital requirements have conceived a foolproof method of setting accurate capital floors. The reason behind this failure stems from the inability of anyone, whether it be regulators or industry experts, to assess the true nature of the risk. The problem lies in the fact that swap technology outpaces the ability of anyone to grasp the spectrum of risks associated with the transactions. Since regulation cannot accelerate the understanding process, heightened regulation only can delay technological advances in swaps until they are better understood. If the unknown risks of arcane swaps truly pose a danger to the consumer and to the market, regulation should suppress their introduction into the market. Much in the manner as the Food and Drug Administration (FDA) tests new drugs before allowing them to hit the shelves, perhaps a regulatory body should analyze new swaps before allowing investment firms to market them.

Swap dealers would argue that swaps are not marketed to the public; in fact, each swap is a contract with an individual party for a unique product. Therefore, to regulate such an agreement would be to interfere with the right of two consenting parties to form a mutual agreement. The parties recognize that they cannot accurately assess the risk of the transaction, and they build this uncertainty into the contract price. Further, customers neither

need nor demand added regulation. Most swap customers are sophisticated investors¹⁴⁶ who have the capability to understand the nature of their transactions, and as such are able to “fend for themselves.”¹⁴⁷ Nor do dealers require added regulation. Profit maximizing forces will ensure that dealers who misconstrue the risk factors will overcompensate for unquantifiable risk, and will not err in reverse.¹⁴⁸ Thus, even in the absence of accurate capital requirements, the chance of a dealer failure, and the ripple effect on the financial markets which accompanies it, is minimal. Since swaps pose no significant danger to consumers and the marketplace, restraining new swap transactions until regulators understand the extent of the risk serves no purpose. Such legislation would merely hamper innovative instruments from reaching consumers who demand them, which again runs counter to the CFTC philosophy of promoting product proliferation.

However, the lack of swap regulation serves to exclude unsophisticated and non-institutional parties from the swap market. While dealers seldom considered these parties to be swap candidates in the past, increasingly in the future, dealers looking to expand their customer base will sell smaller, less sophisticated businesspeople on the benefits of swap transactions.¹⁴⁹ Certainly these investors require protection no less than do smaller investors in more traditional securities and commodities, which are heavily regulated.

The second potential problem with the current regulatory structure is an absence of regulatory certainty regarding instances of fraud in the swap market. By exempting swaps from regulation, the CFTC intended to provide “legal certainty” regarding the status of swap transactions.¹⁵⁰ The FTPA and the related CFTC rules achieved legal certainty by eliminating the legal risk that swap contracts might be overturned on the grounds that as futures contracts they violate the exchange trading requirement of section 4(a) of the CEA.¹⁵¹ If the exemption did not exist, a finding that one

146. See Hu, *supra* note 93, at 1459.

147. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (Citing only to the quote, not to the nature of swap investors. The case stands for the proposition that regulation, by means of the 1933 Act, is unnecessary if the subjects of the regulation are not in need of protection.)

148. See *supra* note 94 and accompanying text.

149. Congress recognizes that swap consumers “may be reaching the next tier of institutional investor,” namely, small institutions. *House Hearing, supra* note 1.

150. Vicky Stamas, *Commodities Rule Could Energize Trading in Swaps*, THE BOND BUYER, Oct. 19, 1992, at 34 (quoting former CFTC chairwoman Wendy Gramm).

151. Robert J. McKay, *The Search for Regulatory Certainty*, INST’L INVESTOR, Dec. 1992, at Supp. 9, Supp. 10.

specific swap transaction qualified as a futures contract would threaten the viability of the entire swap market, which would result in severe consequences for the entire banking system. Until legal certainty was provided, swap participants were forced to factor the risk of such a finding into the contract price. These increased transactions costs raised the price of conducting swap agreements both to dealers and end-users. In addition, the absence of legal certainty scared away risk-averse swap engineers who feared their new instruments might fail a legal challenge. By injecting legal certainty into the swap market, the current regulatory regime promotes innovative product development.¹⁵²

While recent legislative and CFTC actions impose legal certainty, lawmakers have failed to address the issue of regulatory certainty. In other words, the questions of whether and how swaps ultimately should be regulated and who should regulate them remain unclear. The CFTC has yet to pronounce firmly that a swap qualifies as a futures contract. The SEC has expressed no opinion as to whether a swap meets the definition of a security. As was the case prior to the introduction of legal certainty into the swap market, a single court holding that swaps belong under the jurisdiction of either the CFTC or the SEC alone would drastically impact the financial marketplace. As the regulatory status of swap transactions lies in abeyance, swap participants incur additional transactions costs. These transaction costs are not associated with evaluating risk. Instead, the costs stem from the inability of both parties to form identical expectations as to the contingencies of the contract. The degree of uncertainty prevents a meeting of the minds between the two parties since neither can be sure which agency, if any, will protect the transaction.

The problem of regulatory uncertainty becomes particularly acute concerning the issue of fraud. Under the current regulatory structure, the exact manner in which an instance of fraud would be handled is unclear. To date, no fraud cases have been brought before courts or to the attention of any regulatory agencies. The CFTC has proclaimed that the antifraud provisions of the CEA¹⁵³ apply to swap transactions.¹⁵⁴ But since the CEA only applies to instruments defined as futures contracts, if a court

152. Stamas, *supra* note 150, at 34.

153. 7 U.S.C. § 9 (1988).

154. 'Swaps' Market Won't Face Regulation, But Rules Against Fraud, Manipulation Will Apply, *supra* note 100, at G5.

declares a swap not to be a futures contract, the antifraud provisions of the CEA will not be triggered. Further, the ambiguity of the status of the SEC in the regulatory paradigm raises questions as to whether the antifraud provisions of the 1934 Act might also apply.

C. *Competing Pressures*

Until information barriers for evaluating the risk of swap transactions are removed, no ideal solution can exist. No one, however, seems to be short on ideas, many of which can improve the existing structure. Economist Henry Kaufman proposed a six-point plan for improving the regulatory system.¹⁵⁵ Most notably, the plan provides for the formation of an international organization to oversee and harmonize the various domestic regulatory regimes.¹⁵⁶

In the United States, regulation of swaps provides a showcase for the turf battle between the SEC and the CFTC, causing one commenter to suggest that the struggle for agency power drives regulatory policy more than rational design.¹⁵⁷ Another recommends a merger of the two agencies to provide a unified regulatory approach.¹⁵⁸ For its part, the CFTC, perhaps in an effort to maintain its livelihood, opposes merger of the two agencies which would permit a single agency to govern swaps.¹⁵⁹ The CFTC does suggest increased coordination among the relevant regulatory bodies and favors creating an interagency council to evaluate the need for additional regulation.¹⁶⁰ However, the CFTC recommends “no fundamental [change] in [the] regulatory structure” of swaps.¹⁶¹

Regulators also face competing pressures from swap dealers, who promote laissez-faire, and futures exchanges, which demand the

155. James P. Kraus, *Noted Economist Sounds Warning on Weakness of Swaps Regulation*, AM. BANKER, Oct. 20, 1993, at 30.

156. *Id.*

157. Hazen, *supra* note 12, at 1021.

158. Russo & Vinciguerra, *supra* note 38, at 1495.

159. Lynn Stevens Hume, *Futures Commission Calls for Council of Agencies to Scrutinize Derivatives*, THE BOND BUYER, Oct. 27, 1993, at 1.

160. *Id.*

161. Christi Harlan, *CFTC Ducks the Issue of How to Regulate Derivatives*, WALL ST. J., Oct. 27, 1993, at C1. The CFTC's persistent statements of inaction have been soundly criticized. See Laurie Morse, *Risk and Reward: CFTC Stalls Over Regulation Until Reinforcements Arrive*, FIN. TIMES, Nov. 1, 1993, at 20. “The CFTC's fumbling attempts to get its arms around the OTC [swap] market demonstrate that derivatives regulation is in sad need of realignment.” *Id.*

classification of swaps as futures contracts. While swap dealers have won the initial battle, the war has only begun. Futures exchanges are considering challenging the CFTC exemption for off-exchange swaps.¹⁶² If pressed to a conclusion, such a suit would force the courts to grapple with and firmly decide the benchmark issue of whether a swap constitutes a futures contract. When considering this issue, courts should not only weigh the traditional factors which qualify an instrument as a futures contract, but they also should consider the ramifications of a final proclamation that the CFTC possesses exclusive jurisdiction over the swap transactions. Until a court renders such a final proclamation, regulatory uncertainty and the transaction costs which attach to it, cannot be eliminated. In the interim, any agency assertion of jurisdiction will not mitigate the uncertainty since such a proclamation would soon be subject to challenge, and prone to reversal, by a court.

CONCLUSION

Without a doubt, flaws exist in the current regulatory regime. But in analyzing whether the regime should be altered and more intense regulation should be pursued, one question of paramount concern is whether changing the existing structure would improve the current situation. As Chicago Mercantile Exchange Chairman William Brodsky stated, "when there is an issue of market safety, people have the tendency to regulate."¹⁶³ Before plunging into regulation, lawmakers should conduct a traditional cost-benefit analysis to ensure that regulation protects more than amorphous concerns.¹⁶⁴ Added regulation pertaining to evaluation of risk factors serves no useful end, since regulators themselves cannot accurately assess the risks of complex swap transactions. Overzealous regulation pursued unilaterally by the United States serves only to increase internal and external costs of transactions, reducing incentives for innovation and causing U.S. swap dealers to lose business to competitors overseas who have the benefit of less regulated markets.

162. *Dingell Rejects Challenge on CFTC Swap Exemptions*, DERIVATIVES WEEK, Jan. 11, 1993, at 1.

163. William Brodsky, Address at the JFK School of Government, Harvard University (C-SPAN television broadcast, Dec. 17, 1992).

164. *Id.*

New York Stock Exchange chairman William Donaldson claims that “custom made interest rate swaps” pose the greatest risk to orderly markets worldwide.¹⁶⁵ Yet merely because a risk exists does not mean that increased regulation will mitigate the risk. It is easy to endorse free market economics when no major shocks to the global system have occurred. However, with the burgeoning popularity of swap transactions, problems are inevitable. When such problems arise, U.S. regulators should not submit to political pressures and battles for jurisdiction. A globalized swap market demands a common global solution. In order to address the problem effectively, all nations in which swap transactions are conducted must unite on a single mode of regulation, even if regulation merely takes the form of *laissez-faire*.

165. William Donaldson, Chairman, New York Stock Exchange, Address at the JFK School of Government, Harvard University (C-SPAN television broadcast, Dec. 17, 1992).