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Introduction

In an article from 2000, an investigative journalist from *The Banker* warned against the hidden dangers of credit default swaps (CDS).[1] Although CDSs can be a useful financial instrument for the banking industry,[2] the article warned of the anonymity of credit derivatives,[3]

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[1] *See generally* Jules Stewart, *Hidden Dangers of Credit Swaps,* Banker, Dec. 2000, at 74 (outlining the dangers of the reliance on CDSs).

[2] *See* René M. Stulz, *In Defense of Derivatives and How to Regulate Them*, Wall St. J., April 7, 2009, at A15 (explaining that derivatives allow businesses to hedge risk and credit derivatives allow lenders to offer credit on better terms, thus promoting business growth).

[3] *See* Stewart, *supra* note 1, at 74 ("Then there is the issue of the anonymity of credit derivatives, such that corporations have no idea who is exposed to them and only find out when something goes wrong.").

lack of transparency,[4] and the potential for disaster.[5] In an unfortunately accurate conclusion, the journalist opined that a crisis might occur because banks may not put in place the proper risk control systems in time to avert a disaster.[6] Fast forward eight years and the financial meltdown of 2008 developed into one of the largest economic disasters in history.[7] Banks and other large market actors had taken risk and, in many cases, reckless financial positions that put them at the brink of bankruptcy.[8] The ensuing bailout targeted some of the largest financial entities, but the damage to the financial markets had already occurred.[9] While many individuals debate about what factors caused the financial meltdown, regulators and Congress pointed to CDSs as a contributing factor to the financial meltdown.[10] At one point, American International Group, Inc. (AIG), owed in excess of $400 billion to counterparties in CDS contracts and this was money that AIG simply did not have.[11]

CDSs, as financial instruments, are both beneficial and detrimental.[12] CDSs do not necessarily create instability, but the contracts can be conduits of instability by shifting the risk of default onto another entity. This receiving entity, on the other hand, can be ill-equipped to deal with this new risk, even though it views itself as capable.[13] Regardless

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[4] *Id.* at 76 (stating that even though no one knows who holds credit risk to a particular name at any point, the bankers who deal with credit derivatives prefer the instruments because it enables banks to manage their credit risk discreetly without affecting customer relations. "This lack of transparency . . . could open the door to a chaotic situation.").

[5] *Id.* at 74 ("One analyst who follows the sector says: 'If banks fail to get to grips with the operational risks of credit derivatives they could find that they create more problems than they solve – in which case, credit derivatives could end up triggering a banking crisis rather than averting one.'").

[6] *Id.* at 77 ("[T]he fear is that it will take a crisis before banks put proper risk control systems in place.").

[7] RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION vii (2009) ("A vocabulary rich only in euphemisms calls what has happened to the economy a 'recession.' We are well beyond that. We are in the midst of the biggest economic crisis since the Great Depression of the 1930s.").

[8] Jerome A. Madden, *A Weapon of Mass Destruction Strikes: Credit Default Swaps Bring Down AIG and Lehman Brothers*, 8 AM. U. BUS. L. BRIEF 15, 15 (2008) (chronicling the financial crisis through AIG and actions from regulators).

[9] *AIG and The Trouble With Credit Default Swaps'*, NPR (Sept. 18, 2008), http://www.npr.org/templates/story/story.php?storyId=94748529&ps=rs (explaining that the large size of the CDS business was enough to make the failure of AIG a global economic threat and there was a fear that AIG's insurance banks across the world would be at risk).

[10] *Id.*

[11] Alex Blumberg, *Unregulated Credit Default Swaps Led to Weakness*, NPR (Oct. 31, 2008), http://www.npr.org/templates/story/story.php?storyId =96395271.

[12] René M. Stulz, *Credit Default Swaps and the Credit Crisis* 7 (European Corporate Governance Inst., Working Paper No. 264, 2009) *available at* http://www.ecgi.org/wp/wp_id.php?id=400 ("Credit default swaps have both social benefits and social costs. The social benefits are that they make it easier for credit risk to be borne by those who are in the best position to bear them that they enable finance institutions to make loans they would not otherwise be able to make, and that their trading reveals useful information about credit risk.").

[13] *See e.g.*, Anupan Chander & Randall Costa, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 649–50 ("AIG and Lehman, both highly regulated, capi-

of the benefits of CDS transactions, the public viewed the financial derivative as dangerous.

Due to the public's anger, there was substantial impetuousness in Congress to create new legislation to prevent another market wide failure. Both the U.S. House of Representatives[14] and U.S. Senate[15] proposed their own pieces of legislation, and, in June of 2010, President Barack Obama signed the financial reform bill. Part I of this paper will discuss CDSs and the swap market. Part II will review the prior law, which governed CDSs, and the changes being made to this law by the financial reform bill. Part III will discuss, in a qualitative manner, how these changes will affect CDS contracts and the market for these contracts and whether clearing CDSs will adequately address the issues within the financial markets. Part IV will discuss the governance issues that still underlie the CDS markets and the impact of the new legislation on governance and trading.

Part I

A. What are Credit Default Swaps?

CDSs are financial instruments that create an exchange of payments based on the credit performance of an underlying asset.[16] The company buying the CDS protection is hedging against some credit exposure it has to the underlying asset and the seller of the CDS is willing to take on that risk to get a stream of payments from the CDS buyer.[17] If the underlying asset falters (and the exact definition of "falter" is specified in the contract between the two parties), then the CDS seller must make a payment. That payment may be in the form of making the CDS buyer whole on the investment, in the underlying asset, or may be a contractually predetermined amount of money or securities.[18] If the underlying asset never falters, the CDS buyer continues to pay the

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tal-supervised entities, proved insufficiently capitalized to avoid default. . . . AIG's counterparties allowed AIG an exemption from both initial margin and variation margin payments.").

[14] H.R. 4173, 111th Cong. (2010).

[15] S. 3217, 111th Cong. (2010).

[16] Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019, 1021 (2007).

[17] *See id.* ("We define credit derivatives as financial instruments whose payoffs are linked in some way to a change in credit quality of an issuer or issuers.").

[18] Viral V. Acharya, Robert F. Engle, Stephen Figlewski, Anthony W. Lynch & Marti G. Subrahmanyam, *Centralized Clearing for Credit Derivatives*, *in* Restoring Financial Stability: How to Repair a Failed System 251, 254 (Viral V. Acharya & Matthew Richardson eds., 2009) [hereinafter Restoring Financial Stability] ("[T]he protection seller is exposed to the risk that the reference entity (the firm or sovereign borrower the CDS is written on) will default. If that happens, the seller is immediately liable for the default loss on the obligor's debt, which can be as much as the entire principal amount of the CDS.").

stream of payments necessary to keep the contract in force, until the contract expires.

The best example of the incentives behind CDSs is a bank lending to a large corporation.[19] Although the bank is well aware of the risk they have taken and have considered the risk in their interest rate, the corporation may want more money and the bank may not be willing to make those additional loans.[20] The bank can make the additional loans and also hedge the risk that the corporation will default on its debt.[21] Thus, the bank makes the loan and then creates a CDS contract with another financial entity.[22] The financial entity receives a stream of payments, while the bank has the protection of knowing that if the corporation defaults on the debt, the financial entity will make a payment to the bank.[23]

From this simple example, it is clear that CDSs have the potential to be beneficial financial instruments. By transferring the risk from the CDS buyer to the CDS seller, there is, supposedly, a more efficient outcome because the party who is interested in carrying the risk of the investment is the party that receives the risk.[24] In an ideal situation, collateral on the contract will reflect the inherent risks, such as one party may not perform on the contract. Thus, if a financial organization owns bonds in a company and is worried that the company will default, the financial organization can manage that risk by using CDSs.[25] By having the risk hedged, the financial organization can lend to others and invest in other ventures.[26] There is also the potential, however, that CDSs may be abused or simply misused. The contracts appear as simple transactions, but problems may arise quickly. What if the financial entity cannot make the final payment? Or what if the financial entity has entered into so many CDS contracts that there is no way it can make all the payments?[27]

[19] *See, e.g.*, Partnoy & Skeel, *supra* note 16, at 1023 (using General Motors as an example of the incentives driving banks to make loans to large corporations).

[20] *See AIG and The Trouble With 'Credit Default Swaps,'* NPR (Sept. 18, 2008), http://www.npr.org/templates/story/story.php?storyId=94748529&ps=rs.

[21] *See* Partnoy & Skeel, *supra* note 16, at 1023 ("If the bank would rather oversee the loan itself (or minimize the size of its syndicate), credit default swaps provide an alternative method for laying off some of the risk. By purchasing credit default swaps, the bank can handle the loan and lending relationship itself, and reduce the potential downside costs of a default by the borrower.").

[22] *See id.*

[23] *See* Sherri Venokur, Matthew Magidson & Adam M. Singer, *Comparing Credit Default Swaps or Insurance Contracts: Did the New York State Insurance Department Get it Right?*, 28 FUTURES & DERIVATIVES L. REP. 1, 3 (2008).

[24] *See* Partnoy & Skeel, *supra* note 16, at 1022–24.

[25] Rene M. Stulz, *In Defense of Derivatives and How to Regulate Them*, WALL ST. J., Apr. 7, 2009, at A15.

[26] *Id.*

[27] *See generally* Chander & Costa, *supra* note 13, at 649–50 ("[I]n the case of AIG, it became apparent that the bilateral, private, and unregulated character of the market had allowed AIG's dealer counterparties to relax their margin rules, relying in part on AIG's overall high credit ratings and perceived balance sheet strength.").

B. WHO ARE THE MARKET PARTICIPANTS?

CDSs are considered "over the counter derivatives" because they are not cleared by a clearinghouse or placed on an exchange.[28] Market participants execute CDS agreements bilaterally.[29] The market participants include dealers, end-users, and speculators.[30]

Similar to clearinghouses, dealers act as the intermediary for the many end-users that contract with the dealer and then hedge their exposure to each contract by offsetting the trade.[31] However, these dealers do not impose any of the rules that established clearinghouses enforce.[32] Prior to the economic meltdown, the largest dealers in the United States were Wachovia & Company, Citibank, and JPMorgan Chase & Co., and the largest foreign dealers included Deutsche Bank Group, UBS AG, and ABN AMRO Bank N.V.[33] Investment banks, such as Morgan Stanley Companies, Inc.; Bear Stearns; Goldman Sachs; and insurance companies, such as AIG and Swiss Re, were also active in the market.[34]

End-users can include large and small corporations or any other organization and individual looking to hedge a particular transaction or to hedge business risks, such as the volatility of interest rates and commodity prices.[35] End-users tend to have a specific purpose for being in the market or they have an interest in the underlying transaction they are hedging.[36] On the other hand, speculators are a larger group of individuals who use the market to make a profit from market

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[28] Michael Kent, *OTC Derivative Regulation – the Benefits of Clearing*, 30 FUTURES & DERIVATIVES L. REP. 13, 14 (2010) ("OTC markets have traditionally not involved clearing, as the products have included non-standardized contracts which could not be traded on exchange.").

[29] *See* Partnoy & Skeel, *supra* note 16, at 1021 ("[A] credit default swap is a private contract in which private parties bet on a debt issuer's bankruptcy, default, or restructuring.").

[30] CHRISTIAN A. JOHNSON, THE GUIDE TO USING AND NEGOTIATING OTC DERIVATIVES DOCUMENTATION 4 (2005) [hereinafter OCI DERIVATIVES DOCUMENTATION] ("The OTC derivative industry is composed primarily of three different categories of participants: dealers, end-users, and speculators.").

[31] *See id.* ("The dealer takes one side of a trade with one end-user and then enters into an offsetting trade with another end-user.").

[32] *See generally* Christian Johnson, *The Enigma of Clearing: Buy Side OTC Derivatives*, 29 FUTURES & DERIVATIVES L. REP. 1, 7 (Dec. 2009) [hereinafter *Enigma of Clearing*] (explaining that due to the new regulations requiring OTC derivatives to be cleared, clearinghouses will have to "develop backoffices and processes that banks and other dealers have spent years cultivating and refining.").

[33] OTC DERIVATIVES DOCUMENTATION, *supra* note 29, at 4–5 ("The largest dealers in the OTC market in the United States [were] the large money center and regional banks such as Wachovia, Citibank, and JPMorgan Chase. . . . Foreign bank[s] [were] also major participants. . . . [including] Deutsche Bank, UBS AG, and ABN AMRO.").

[34] *Id.* at 5 ("Large investment banks such as Morgan Stanley, Bear Stearns, and Goldman Sachs are also prominent in derivatives.").

[35] *See generally Enigma of Clearing*, *supra* note 32, at 4 (explaining that "the buy side . . . demand[s] customized derivative products from dealers to meet hedging requirements and other needs that were not available through exchanges and clearinghouses").

[36] *Id.*

movements.[37] Speculators can include hedge funds, financial institutions, dealers, or end-users.[38]

C. WHAT ARE CDS CONTRACTS?

The International Swaps and Derivatives Association (ISDA) has standardized documentation for many swap agreements.[39] A CDS agreement includes a Confirmation, ISDA Master Agreement, Schedule, and Credit Support Documents.[40] While the basic documents are standardized, the market participants still have control over many parts of the transaction, especially in comparison to other derivative instruments that are traded over regulated exchanges and clearinghouses.[41] Market participants can specify the trigger event, collateral, and the stream of payments to keep the contract "alive." The ability to customize a CDS contract gives market participants a tremendous amount of flexibility but can also bring about liquidity and credit risk. A customized contract allows market participants to minimize the basis or correlation risk, which is the risk that the product does not match the underlying risk to be hedged. The benefit of a clearinghouse lies in the economies of scale, in that the clearinghouses provide greater liquidity by standardizing contracts.[42]

PART II

A. IN WITH THE NEW, OUT WITH THE OLD; CDS TRANSITION FROM OVER-THE-COUNTER DERIVATIVES TO THE CLEARINGHOUSE

Swaps were exempt from regulation because of amendments made to the Commodity Exchange Act (CEA)[43] by the Commodity Futures Modernization Act of 2000 (CFMA).[44] Prior to the CFMA amendments, the derivatives market participants had expressed concern over whether

[37] OTC DERIVATIVES DOCUMENTATION, *supra* note 30, at 6–7.

[38] *Id.* ("[Speculators] typically includes hedge funds and other similar financial institutions, but may also include dealers or end-users attempting to profit from market movements.").

[39] *Id.* at 7 (referring to the ISDA Master Agreement, which is used in "virtually every contractual relationship governing the use of OTC derivatives").

[40] *Id.* at 14–15 (noting that the ISDA Master Agreement has simplified, formalized, and lowered costs of OTC derivative transactions).

[41] *See generally* Ward Bortz & Jeffrey A. Rosenberg, *The Big Bang: A Guide to the Standardized CDS Contract*, 29 FUTURES & DERIVATIVES L. REP. 10 (May 2009) (discussing the various contract provisions, which are amendments to the CDS contract, enacted through an ISDA protocol and supplement).

[42] Sharon Brown-Hruska, *The Derivatives Marketplace: Exchanges and the Over-the-Counter Market,* FINANCIAL DERIVATIVES 23 (Robert W. Kolb & James A. Overdahl eds., 2010).

[43] 7 U.S.C. § 1.

[44] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 303, 114 Stat. 2763 (2000).

CDS contracts were exempt from registration, and the CFMA amendments clarified and provided assurance that CDS contracts were not subject to regulation by the Commodity Futures Trading Commission (CFTC).[45] The CFMA solidified the exemption for swaps by adding 7 U.S.C. § 2(d), 1(a)(13).[46] Section § 2(d) of the CEA states that the CEA does not govern a transaction in an excluded commodity if the transaction is between eligible contract participants and the transaction is not executed on a trading facility.[47] Excluded commodities include credit risk commodities.[48] Eligible contract participants

> include a 'financial institution' and any 'corporation, partnership, proprietorship, organization, trust, or other entity' that has: (i) total assets exceeding $10,000,000 or a net worth exceeding $1,000,000 and (ii) 'enter[ed] into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business.'[49]

Additionally, even though the underlying asset of a CDS contract could be a security, group of securities, or index of securities, CDSs are not regulated as a security-based swap.[50]

Furthermore, there is no requirement that CDSs be traded on exchanges or clearinghouses, and there are no regulations regarding how much collateral should be posted in each CDS contract. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[51] drastically changed the regulatory regime of CDSs, beginning with bringing the financial instruments under the regulatory purview of both the CFTC and the Securities and Exchange Commission (SEC).

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[45] *See Enigma of Clearing*, *supra* note 32, at 4 (Dec. 2009) [hereinafter Enigma of Clearing] ("In an effort to enhance legal certainty and to determine regulatory jurisdiction over the nascent OTC derivatives market, the Commodity Futures Trading Commission issued its 1989 policy statement [stating that] the CFTC [will] not regulate OTC derivatives that were not, in essence, disguised futures.").

[46] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, §§ 101, 103, 114 Stat. 2763 (2000).

[47] 7 U.S.C § 2(d).

[48] 7 U.S.C § 1a(13) ("The term 'excluded commodity' means – (i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure.").

[49] OTC Derivatives Documentation, *supra* note 30, at 95.

[50] *See* Venokur, Magidson & Singer, *supra* note 23, at 6 ("The CFMA effectively excludes CDS Transactions from the registration requirements of the [securities laws] because it clarifies that a swap based on a security is not a security.").

[51] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376.

B. CONGRESSIONAL DEBATE SURROUNDING THE DODD-FRANK ACT AND THE FINAL RESULT

First, the new legislation changed the CEA by striking the provisions that allowed for an exemption for swaps.[52] Additionally, the new legislation amended the securities laws so that security-based swaps are under the regulatory purview of the SEC.[53] Both the Senate and House bills imposed registration requirements on many participants in the CDS markets.[54] Dealers are required to register as "swap dealers", which is defined as any person who, as a significant part of its business, (i) holds himself or herself out as a dealer, (ii) "makes a market in swaps," (iii) regularly engages in the purchase or sale of swaps in the ordinary course of business, or (iv) engages in any activity that would cause such person to be known as a dealer.[55]

Likewise, "major swap participants" are required to register, and the definition includes any person who is not a swap dealer and "maintains a substantial position in outstanding swaps in any major swap category," excluding hedging and mitigating commercial risk, "whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability," or is "highly leveraged relative to the amount of capital it holds."[56] The House intended to define "major swap participant" to encompass those entities that were actively engaged in the swap markets but to allow end-users an exemption, so that end-users would not be subject to collateral and margin requirements. However, this issue was fought on two occasions in the House, in first passing H.R. 4173 and then again during the reconciliation of the Senate and House versions of the financial reform bill. [57]

Before H.R. 4173 was passed in the House, Representative Murphy proposed an amendment that would return the definition of major swap participant to the definition that came out of the Agriculture Committee. While the two definitions seem only slightly different, the difference in wording reflected the differing perspectives towards end-users.[58] The House passed Representative Murphy's amendment and opted for a

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[52] S. 3217, 111th Cong. § 721 (2009).

[53] *Id.* at § 717.

[54] *See infra* notes 59–65.

[55] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 721(49) (2010).

[56] *Id.* at § 721(33).

[57] *See supra* notes 62-66.

[58] *Compare id.* ("[W]hose outstanding swaps create substantial net counterparty exposure among the aggregate of its counterparties that could expose those counterparties to significant credit loss.") *with* 155 CONG. REC. H14712 (daily ed. Dec. 10, 2010) (amendment offered by Rep. Murphy) ("The term 'major swap participant' means any person who is not a swap dealer, and . . . (ii) whose outstanding swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets.") .

more expansive exemption for end-users by labeling an end-user as a major swap participant only if the end-user's outstanding swaps position could create serious adverse effects for U.S. financial stability, as opposed to a swaps position that could expose its counterparties to significant credit loss.[59] Subsequent amendments, such as those which would allow regulators to set a margin in swap transaction involving end-users and another amendment that would maintain the clearing exemption for end-users but require end-users to report the transaction on an exchange, were also voted down to provide end-users with added protection.[60] While in both cases, the amendments were geared towards creating additional stability and transparency; both amendments would impose additional requirements and obligations on end-users that a majority of the House did not want to impose on end-users. However, the Conference Committee, tasked with reconciling both versions of H.R. 4173, undid much of this work, and subsequent debates over the changes reflected a deep concern over the impact of H.R. 4173 on end-users.[61]

In the final debate over H.R. 4173, the language in the derivative portion of the bill was debated heatedly, and a final amendment to H.R. 4173 to return the language in the derivatives bill to the original House version was voted down.[62] At the forefront of the debate was the level of regulation over end-users. Both the Senate and the House bill had a type of end-user exception; however, the clearly delineated exemption for end-users did not make it into the final bill. Instead, the definition of "major swap participant" attempted to strike a balance when end-users may fall within the definition and thus would have to register as "major swap participants."[63] The final bill included an exemption from

[59] 155 Cong. Rec. H14,712 (daily ed. Dec. 10, 2010) (In opposition to Rep. Murphy's amendment, Rep. Frank: "The bill that is in there now, and it differs from the Agriculture bill, says if the end user is causing financial losses and problems at a particular counterparty, then you should not have the exemption. The alternative is to say no, let's not step in if this or that or many counterparties are in problems until it could become a systemic risk. We don't want to wait for systemic risk. I don't want to wait until people are at the edge of the cliff to start to pull them back.").

[60] H.R. Rep. No. 111–370, at 11 (2009).

[61] *See supra* notes 62-66.

[62] *See* 156 Cong. Rec. H5,227 (daily ed. June 30, 2010) (statement of Rep. Garrett) ("Unfortunately, not a single Democrat supported that House language in the final vote, despite the fact that very same language was originally sponsored by the . . . chairman.").

[63] *See* 155 Cong. Rec. H14,713 (daily ed. Dec. 10, 2009) (statement of Rep. Frank) ("I support an end user exemption. But when an end user is employing that exemption in a way that puts counterparties at risk, I don't want to have to wait until a cataclysm impends. I would like there to be the ability to step in and stop it at that point.").

clearing for counterparties that meant the clearing exemption requirements.[64] While regulators would be able to impose margin requirements on swap dealers and major swap participants, these requirements are not meant to be imposed on end-users, unless the end-user falls into the definition of a major swap participant.[65] This was little consolation to those in Congress who would have preferred an absolute exemption for end-users. Multiple amendments were proposed to solidify an exemption for end-users; however, all the amendments were subsequently voted down in the Conference Committee. While the intent of Congress is that end-users should not be subjected to burdensome margin requirements,[66] the current exemption from clearing is vague,[67] and there could be a potential for further problems.

PART III

Even before the legislation was complete, the CDS market had already begun the standardization and clearing process.[68] The inevitable question that remains, however, is what standardization and clearing will do for the market. Integral to this question is figuring out the problem we are trying to solve. Some of the important benefits of CDSs are the liquidity they produce in the market, the increased opportunities for hedging, and a more efficient market for trading credit risk.[69] By being able to hedge against the loans a bank offers, those banks decrease their risk of being adversely affected if companies later default on those loans.[70] Additionally, because these banks can lend at lower risk, there is increased liquidity in the banking industry, analogous to the result of

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[64] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 723 (7)(1)(A) ("Clearing requirements shall not apply to a swap if 1 of the counterparties to the swap — (i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.").

[65] 156 CONG. REC. H5,248 (daily ed. June 30, 2010) (statement of Rep. Peterson) (emphasizing that regulators have been given no authority to impose margin requirements on anyone other than swap dealers or major swap participants and that few end users would fall under the "major swap participant" definition because "positions held for hedging or mitigating commercial risk" are excluded from being considered as a "substantial position.").

[66] *See* 156 CONG. REC. H5,248 (daily ed. June 30, 2010) (statement of Rep. Frank) (stating that marginal requirements are not required for end-users).

[67] H.R. 4173, 111th Cong. § 723(h)(7) (2010) (stating that swaps are not required to be cleared if one party to the transaction is not a financial entity and is using swaps to hedge or mitigate commercial risk).

[68] *See Enigma of Clearing*, *supra* note 32, at 6 (explaining that there has already been success in clearing credit default swaps).

[69] Partnoy & Skeel, *supra* note 16, at 1022 (discussing the benefits of credit derivatives).

[70] *Id.* at 1024 ("Alan Greenspan and others have argued that credit derivatives served as a shock absorber during the corporate crises of 2001 and 2002. Because many of the lenders to companies like Enron and WorldCom had hedged their risk, the corporate scandals did not spread to the banking industry.").

securitization on home mortgage lending.[71] With that increased liquidity, there is also increased information. The prices of the CDSs provide another source of information about a company's financial health.[72]

A. The Problems in the Market and the Potential Solutions

However, the market is not without serious problems. The problems include systemic risk, limited disclosures, and incentives against monitoring. Due to the opacity of the credit default market and the limited disclosures, it is unclear what the contractual agreements are and who actually holds what positions.[73] This issue further exacerbated the systemic risk concerns of counterparties performing on the contracts and the operational risk of proper settlement.[74] Since collateral and margin requirements are decided in each contract independently of any other contract, there is little understanding of the true counterparty risk and the inability to ascertain whether adequate collateral has been posted.[75]

Inherent in the CDS market is the issue of monitoring incentives.[76] In their traditional roles, banks reserved the option to step in and assist debtors before bankruptcy occurred.[77] Thus, banks had a role in corporate governance due to their investment in the company. CDS contracts, however, incentivize banks to hedge against their lending risk instead of beefing up corporate governance.[78] These four interrelated issues (monitoring disincentives, systemic risk, manipulation/mispric-

[71] *Id.* at 1025 ("Because swaps limit the bank's downside risk (and pass it on to other parties, such as insurance companies and pension funds), bank are willing to lend much more money to many more businesses. Credit default swaps thus significantly expand companies' access to capital from bank lending.").

[72] *See id.* at 1026 (stating that while CDS contracts are another source of market-based information, that information also needs to be disclosed or available to the market).

[73] *Id.* at 1036.

[74] *See* Viral V. Acharya, Robert F. Engle, Stephen Figlewski, Anthony W. Lynch & Marti G. Subrahmanyam, *Centralized Clearing for Credit Derivatives*, *in* Restoring Financial Stability: How to Repair a Failed System 251, 252 (Viral V. Acharya & Matthew Richardson eds., 2009) ("Each party in an OTC contract bears the risk that the counterparty will fail to fulfill its obligation in the futures. Operational risk creates uncertainty about whether OTC trades will be cleared and settled in an orderly manner.").

[75] *Id.*

[76] René M. Stulz, *Credit Default Swaps and the Credit Crisis* 7 (European Corporate Governance Inst., Working Paper No. 264, 2009), *available at* http://www.ecgi.org/wp/wp_id.php?id=400 ("The separation of risk-bearing and funding made possible by credit derivatives has the potential to create problems in that lenders who fund companies but do not bear their risks have less incentive to monitor their loans.").

[77] Partnoy & Skeel, *supra* note 16, at 1022 ("In the standard account of banks' role in corporate governance, particularly as the borrower's fortunes deteriorate, banks are the muscular superheroes who step in and take charge to right the troubled ship.").

[78] *Id.* at 1033 ("The banks that financed Enron had used massive amounts of credit derivatives to limit their exposure in the event Enron defaulted — by one estimate, they used more than 800 swaps to law of $8 billion of Enron risk. . . . [T]he prospect of Enron's decline meant must less to Enron's banks than if their loans were fully exposed.").

ing, and limited disclosures) reflect the overlying problems within the CDS markets. Specifically, regulators have honed in on the counterparty and operation risk and the lack of transparency for allowing systemic risk exposures to grow without being noticed.

B. WILL THE PROPOSED LEGISLATION SOLVE THESE PROBLEMS?

Integral to the proposed legislation is shifting over-the-counter derivatives to clearinghouses.[79] As with any policy decision, there are advantages and disadvantages. Clearinghouses are beneficial because the clearinghouse achieves both risk-reduction and risk-spreading.[80] The clearinghouse achieves a degree of risk-spreading by interposing itself between all the clearing members and becoming the counterparty to every transaction.[81] The clearinghouse sets the collateral requirements to daily reflect the contracts assumed by the traders and the changes in value of the position, which is referred to as "mark-to-market." Moreover, the clearinghouse is able to reduce risk through "netting" contracts.[82] Netting is a strategy that offsets matching and opposing trades to minimize the risks associated with settlement.[83]

Nonetheless, before a derivatives contract is eligible for clearing, the contract must be adequately standardized to allow for easy trading and netting. While various articles have made arguments against the standardization of over-the-counter derivatives,[84] CDSs have already begun the transition to clearinghouses.[85] To reiterate, H.R. 4173 would put over-the-counter derivatives on clearinghouses if the clearinghouses accept those derivatives, and the CFTC/SEC states that those derivatives need to be cleared.[86] While the end-user exemption from

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[79] *See Enigma of Clearing*, *supra* note 32, at 4 ("The recently passed House Bill and the proposed Senate Finance Committee bill each impose clearing requirements on OTC derivatives.").

[80] Richard Dale, *Risk Management in U.S. Derivatives Clearing Houses*, 14 ESSAYS IN INTERNATIONAL FINANCIAL & ECONOMIC LAW 8 (1998).

[81] *Id.*

[82] Alex Blumberg, *Unregulated Credit Default Swaps Led to Weakness*, NPR (Oct. 31, 2008), http://www.npr.org/templates/story/story.php?storyId= 96395271.

[83] Sharon Brown-Hruska, *The Derivatives Marketplace: Exchanges and the Over-the-Counter Market,* FINANCIAL DERIVATIVES 31 (Robert W. Kolb & James A. Overdahl eds., 2010).

[84] *See, e.g.*, Jonathan D. Gupta, *Modernizing the Infrastructure for OTC Derivatives: CDS Central Counterparties and Other Industry Initiatives to Address Systemic, Counterparty and Operational Risks in Derivatives Trades*, 29 FUTURES & DERIVATIVES L. REP. 11, 14 (Mar. 2009) ("[R]egulators have also emphasized the importance of customized [over-the-counter] transactions to the efficient functioning of financial markets.").

[85] Press Release, IntercontinentalExchange, Inc., ICE Trust Marks One-Year Anniversary for North American CDS Clearing; Expanded Set of Initiatives in First Half 2010; $6.4 Trillion Cleared by ICE on a Global Basis (Mar. 9, 2010), *available at* http://ir.theice.com/releasedetail.cfm?ReleaseID=450426.

[86] *See* discussion *supra* Part II.

clearing was highly debated, the intent of Congress was for end-users to be mostly free from margin requirements. [87]

However, clearing may not necessarily be the solution to the entire over-the-counter derivatives problem. While a substantial amount of CDS contracts have been standardized and cleared, there is an increased cost associated with clearing.[88] The market participants most harmed by the lack of tailored contracts are, allegedly, the buy side or end-users. These market participants tend to have an underlying connection to the asset they are trying to hedge and, thus, seek tailored contracts to hedge against their specific risk.[89] In addition, while trading derivatives using clearinghouse procedures is less risky, there also may be limited utility due to small market share for some contracts.[90]

However, arguments against standardization do not minimize the benefits of clearing. The new financial legislation balances the ability of end-users to opt-out of clearing requirements while creating a threshold where end-users would no longer be eligible for those exemptions. In addition, clearing includes safety precautions, such as ensuring market participants are aware of their losses and gains daily.[91] The disadvantage of a clearinghouse is that the clearinghouse is solely responsible for maintaining near-zero counterparty risk and, thus, may be susceptible to "too big to fail" concerns.[92]

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[87] *See* 156 Cong. Rec. H5,248 (daily ed. June 30, 2010) (statement of Rep. Frank) (stating that marginal requirements are not required for end-users).

[88] *See* Acharya, *supra* note 74, at 262–63 ("A bigger issue is resistance from large players to move trading from OTC markets to centralized exchanges, because they benefit from lack of transparency of OTC markets and would likely be required to post higher collateral to clearinghouses and exchanges.").

[89] *See Enigma of Clearing*, *supra* note 32, at 5 ("The buy side has specific and customized needs for its use of OTC derivatives and would resist using 'cleared' OTC derivatives that cannot be highly customized or derivatives that have become too expensive or cumbersome due to increased margining requirements or regulation.").

[90] *See* Gupta, *supra* note 84, at 14 ("[T]he CFTC has observed that certain listed credit derivative products in the past have been unable to gain significant market share, observing that 'the utility of some customized off-exchange instruments might be lost if they become sufficiently standardized . . . .").

[91] *See id*. ("[T]hese critical risk management functions prevent small losses from accumulating unnoticed.").

[92] *See* Mark J. Roe, Opinion, *Derivatives Clearinghouses Are No Magic Bullet*, Wall. St. J., May 6, 2010, *available at* http://online.wsj.com/article/ SB10001424052748703871904575216251915383146.html ("[S]ince a clearing-house is itself at risk of being too big to fail, regulators need to police its capital and collateral requirements. If the derivatives market sees the clearinghouse as too big to fail, the potential for derivatives players making overly risky derivatives trades becomes real.").

PART IV

A. GOVERNANCE

There are multiple benefits to the clearing system; however, the question that still lingers is whether clearing CDS contracts will solve the problems that plagued corporations like AIG.[93] Implicit in the government regulation is that clearing will prevent the occurrence of a "market failure" and financial crisis. However, while clearing will create more transparency, there is also a limit to how helpful clearing will be.[94] The issues of bad corporate governance still underlie the trading choices many companies adopted.[95] Nevertheless, without a stronger duty of care, there remains little more that can be required of corporations.[96] Through the financial crisis, there have been calls for greater shareholder involvement; however, that involvement is only equal to the incentives of the shareholders.[97] Shareholder incentives tend to be limited only to the success of their investment.

Clearing CDSs is far from a novel concept, and the general consensus is that by clearing the CDS contracts, there will be greater transparency within the CDS market and less risk. It also may be the only option left. While the abuse of CDSs has exposed Wall Street's herd mentality towards complicated and sometimes indecipherable financial instruments, greater transparency may be the only real check on Wall Street.[98] Moreover, it is still unclear how CDSs will ultimately impact the monitoring incentives of banks towards their customers.[99] The transparency of the CDS markets could drastically change the way customers view

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[93] *See generally id.* (questioning whether clearing CDS contracts will make the system more risk adverse).

[94] *See* Houman B. Shadab, *Counterparty Regulation and Its Limits: The Evolution of the Credit Default Swaps Market*, 54 N.Y.L. SCH. L. REV. 689, 704 (2009) ("Despite the rapid growth and proliferation of CDSs during the post-turn-of-the-century credit boom and the subprime-mortgage-initiated financial crisis, the risk management practices of CDS counterparties were generally adequate, and the broader infrastructure of the CDS market remained generally stable.").

[95] *See, e.g.*, Madden, *supra* note 8, at 16 (recalling that AIG took a large position in credit default swaps without a hedge).

[96] *See generally* Paul Ali, *Corporate Governance and Derivatives End Users*, *in* PRACTICAL DERIVATIVES: A TRANSACTIONAL APPROACH 9, 11 (Jonathan Denton ed., 2006) (outlining the duty of care expected from corporate governance).

[97] *See generally* Calcina Howson, *When "Good" Corporate Governance Makes "Bad" (Financial) Firms: The Global Crisis and the Limits of Private Law*, 108 MICH. L. REV. FIRST IMPRESSIONS 44, 48 ("In a word, most financial firm shareholders are interested in the current profits of the firm in which they invest, with little regard for the long-term health of the firm itself, and no identifiable interest whatsoever in the entire financial system . . . .").

[98] *See* Felix Salmon, *A Formula for Disaster*, WIRED, Mar. 2009, at 74 (explaining the simple formula for credit ratings, based on real-world data from credit default swaps; unfortunately, the formula was followed without question and the formula was also severely flawed and produced inaccurate results).

[99] *See* Howson, *supra* note 97, at 49 (discussing the fees Wall Street bankers received from these transactions and the lack of monitoring).

the vote of confidence from a bank lending to their company; however, the possibility always remains that the customers could simply take the money and enjoy the lack of monitoring.

B. The Clearing of CDSs is an Imperfect Solution.

While the clearing of CDSs will add transparency to the market, there are still lingering questions regarding whether the proposed legislation may create problems and potential loopholes. The ongoing debate over the exemption for end-users is particularly noticeable.[100] The benefit for this exemption is that companies or individuals who have exposure to the direct asset can tailor their particular CDS contracts to the asset's risk.[101] However, there is also the fear that this exemption will become a loophole within the legislation[102] or, in the alternative, it will unnecessarily restrict market actors. While this issue will only be resolved in subsequent regulations from the CFTC and SEC, it is an issue worth watching.

Conclusion

While the market is still recovering from the financial crisis of 2008, the clearing of CDSs is a policy that has potential to be very beneficial. For CDS contracts, the market is already strongly standardized and moving the contracts through clearinghouses will add to the transparency and security of the market. Through clearinghouses, the CFTC and the SEC can regulate the contracts to prevent manipulation and fraud. In addition, pricing mechanisms will become more accurate due to the transparency of data relating to the actual contracts. While the benefits are yet to be seen, there are also potential disadvantages. The CFTC took a strong stance against a large end-user exemption. The exemption may turn out to be a large loophole in the legislation, or it has the potential to allow end-users to use CDSs for their customized needs.

Regardless, the drastic change to the over-the-counter derivatives market cannot be understated. While this paper focused on CDSs, many over-the-counter derivatives are not as easily standardized, and the job left to the CFTC and SEC to regulate and consider these deriva-

[100] H.R. 4173 § 721.

[101] *See* Rena S. Miller, Cong. Research Serv., R40965, Key Issues in Derivatives Reform, 6 (2009) ("Thus, nearly two-thirds of OTC derivatives involve an end user. If all end users are exempted from the requirement that OTC swaps be cleared, the market structure problems raised by AIG still remain.").

[102] Gary Gensler, Chairman, Commodity Futures Trading Comm., OTC Derivatives Reform, Atlantic Council (Jan. 12, 2010) (asserting that the Wall Street banks benefit from the end-user exemption rather than the businesses using the derivatives).

tives will be immense. The benefits, however, cannot be understated. Regulators and the public cannot take for granted a more transparent and a potentially less risky financial system.