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COMMENT

Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?

JOHN T. LYNCH†

INTRODUCTION

This Comment will focus on the developments in the credit derivatives market in 2005-2006, focusing specifically on the private sector initiative, which addressed problems that had developed in this evolving market during its tremendous growth in recent years. The success of this initiative was a significant accomplishment, not just for the quick and efficient progress made, but because the market was able to self-correct its own industry-wide problems, thereby avoiding the need for direct intervention into the market by an outside regulatory authority.

This initiative will then be discussed, in the context of recent concern over the waning of U.S. financial markets' competitiveness due to perceived regulatory inefficiency, as a model for a proposed regulatory framework that shifts

† J.D. Candidate, University at Buffalo Law School, 2008. I would like to thank Professor Halpern for suggesting that I look at issues in derivatives markets for my Law Review Comment, and the members of the *Buffalo Law Review* for their editorial assistance. I also wish to thank my wife for her patience and my father for his advice while I was researching and writing this Comment.

more authority to markets to self-regulate under the oversight of a consolidated single governmental regulator for all financial markets.

Part I will briefly introduce financial derivatives, and attempt to give the reader a sense of their growing importance in the financial world. Part II will examine the current state of regulation in the derivatives markets. Part III will then explore the credit derivatives market in more detail, orienting the reader to the role of credit derivatives and discussing some basic types and variations of these instruments. Part IV will discuss in detail the recent developments in the credit derivatives markets, and the industry initiative that was able to self-correct the major problems facing that market.

Part V will look at some of the recent concerns for the waning of U.S. competitiveness in the financial markets, focusing on the perceived deficiencies in the current regulatory structure. Finally, Part VI will propose a model for a new regulatory framework *derived* from the initiative used in the credit derivatives market, where the market participants were allowed to address the problems within the market through collaborative effort instigated by joint regulatory concern. This market participant initiative will then be discussed as part of a proposed regulatory structure, where substantial rulemaking authority is shifted to similar initiatives that are guided and enforced by a single governmental regulator which oversees all financial markets through a set of guiding principles.

I. DERIVATIVES, IN GENERAL¹

A. *Derivatives Explained*

In the financial context, derivatives are instruments whose value is measured by reference to an *underlying* contract or asset.² They “derive” their value from the value

1. This Comment assumes some knowledge of derivative financial instruments, and therefore, some of the terminology in that market will not be defined. For a comprehensive introduction to derivatives, see MICHAEL DURBIN, ALL ABOUT DERIVATIVES (2006).

2. “A derivatives transaction is a contract whose value depends on (or ‘derives’ from) the value of an underlying asset, reference rate, or index.” GROUP

of an external *thing*. Another way to look at derivatives is as a form of price guarantee: an agreement between a future buyer and a future seller for something at some designated point in time.³ “They allow investors to place bets on the direction of markets, without ever needing actually to own tangible assets in that market.”⁴ Because of the increasing complexity of variations and innovations in the types and arrangement of derivatives contracts, any more generalized definition is not possible.⁵

Derivatives are not a current invention,⁶ but they are becoming increasingly important in the way that the financial world operates. Derivatives are employed as a way to hedge other positions, to speculate, and as a means of arbitrage. Their versatility is one of their most intriguing and important characteristics.⁷

OF THIRTY, DERIVATIVES: PRACTICES & PRINCIPLES 2 (July 1993). “Underlyings can be anything that interests markets: cash instruments, like stocks and bonds; tangibles, like commodities; or intangibles, like interest rates, currency rates, stock market indices and credit quality.” Norman Menachem Feder, *Deconstructing Over-The-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 681.

3. DURBIN, *supra* note 1, at 1.

4. *A User's Guide to Derivatives*, FIN. TIMES (London), Nov. 18, 2006, at 19 (giving a quick snapshot of the various derivatives markets, including interest rate derivatives, foreign exchange derivatives, credit derivatives, equity derivatives, and commodity derivatives).

5. See Feder, *supra* note 2, at 681 (“Derivatives . . . are hard to define because they vary widely in content and application.”); cf. Saul S. Cohen, *The Challenge of Derivatives*, 63 FORDHAM L. REV. 1993, 1994 (1995) (stating that derivatives are constantly evolving).

6. For a history of derivatives, going back to 2000 B.C., and the development of derivatives in the U.S., see Jerry W. Markham, “Confederate Bonds,” “General Custer,” and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1 (1994).

7. It should be noted that not all financial professionals embrace derivatives. See, e.g., Letter from Warren Buffet, Chairman, Berkshire Hathaway, Inc., to Shareholders, at 15 (Feb. 21, 2003), available at <http://www.berkshirehathaway.com/letters/2002pdf.pdf> (“[D]erivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”). But see, recently, Letter from Warren Buffet, Chairman, Berkshire Hathaway, Inc., to Shareholders, at 17 (Feb. 28, 2007), available at <http://www.berkshirehathaway.com/letters/2006ltr.pdf>:

I should mention that all of the direct currency profits we have realized have come from forward contracts, which are derivatives, and that we have entered into other types of derivatives contracts as well Why, you may wonder, are we fooling around with such potentially toxic

Arbitrage is the strategy of searching for mistakes or discrepancies in pricing across markets and then exploiting those discrepancies by simultaneously buying at one price and selling at another, and profiting from the spread.

Hedging is the practice of taking an offsetting position in one investment to counteract the risk that has been taken in another investment position. This is one of the most significant functions of derivatives: their usefulness and efficiency in allowing parties to allocate risk. Hedging allows a party to take on a "risky" investment opportunity and then re-allocate some or all of that risk to another party, thereby giving up some of the potential return on the initial investment, but at the same time limiting the risk that the initial investment will pose.⁸

Derivatives allow a speculator to take a position based on how he thinks a market will move, but without having to purchase outright the instruments or assets that make up that market.⁹ Speculating and hedging with derivatives

material? The answer is that derivatives, just like stocks and bonds, are sometimes wildly mispriced. For many years, accordingly, we have selectively written derivative contracts—few in number but sometimes for large dollar amounts. We currently have 62 contracts outstanding. I manage them personally, and they are free of counterparty credit risk. So far, these derivative contracts have worked out well for us, producing pre-tax profits in the hundreds of millions of dollars (above and beyond the gains I've itemized from forward foreign-exchange contracts). Though we will experience losses from time to time, we are likely to continue to earn—overall—significant profits from mispriced derivatives.

8. It is important to remember that derivatives do not eliminate the risk of the initial investment, they just reposition it, i.e., lay it off onto another party, allowing the risk to be spread out and reducing each party's exposure to a level that they are comfortable undertaking. See Feder, *supra* note 2, at 683 ("[D]erivatives do not eliminate underlying risk; they only reposition it.").

9. For example, if an investor believed that stock of company XYZ was going to go up in value over the next year, he could either (1) buy the stock and hold it for a year until it appreciated in value; (2) enter into a forward contract for that stock, whereby he agrees to buy some amount of the stock in one year at some designated price (presumably less than he thinks it is going to be at that time); (3) if that stock is traded on a futures exchange, enter into a futures contract for that stock (the primary differences between a futures contract and a forward contract is that the futures contract is standardized and set up at established amounts and intervals, and the transaction takes place on an exchange rather than being negotiated bilaterally); or (4) enter into a long options contract, whereby in exchange for paying a premium, he has the option of buying some amount of that stock at some designated price at some specified time in the future (options are traded on exchanges and bilaterally). These methods are all

both employ the power of leverage, allowing a party to take positions that “focus ‘financial energy’ so hedgers and speculators can get more work done with less effort,”¹⁰ i.e., make more efficient use of their money by tying up less money in each position.

B. *Derivatives Markets*¹¹

Derivatives can be divided into two broad categories: exchange-traded and over-the-counter (OTC). The exchange-traded market tends to have more standardized contracts, and takes place on a central platform where parties act through an intermediary, called a market-maker. The parties do not interact with each other, but rather enter into preestablished contracts with the market-maker who acts as the counterparty both to the buyer and the seller. The exchange-traded market primarily consists of two groups: futures¹² and options.¹³

The OTC market¹⁴ for derivatives consists of parties entering into contracts directly with each other, where they have the ability to formulate transactions that are exactly tailored to their respective needs. This allows for much more innovation and variation, because the parties can negotiate the specific details of the deal directly with each

speculating, but the latter three choices employ simple derivatives to achieve the same result as choice (1) without having to own the stock, thereby leveraging a smaller amount of outlay to achieve the same results.

10. DURBIN, *supra* note 1, at 5.

11. In this section, estimates for the notional amounts outstanding in the exchange-traded and over-the-counter markets are given. However, it should be noted that estimating notional amounts of the markets overstates the risk exposure of the markets since parties hedge positions by taking offsetting positions in other transactions, thereby increasing the notional value of the market, but reducing the market's true exposure to risk.

12. The latest report from the Bank for International Settlements (BIS) estimates that the total global outstanding notional principal amount of exchange-traded futures is almost \$31.7 trillion. BANK FOR INT'L SETTLEMENT, QUARTERLY REVIEW, at A 108 (Sept. 2007), available at http://www.bis.org/publ/qrpdf/r_qa0709.pdf.

13. The BIS estimates the total global outstanding notional principal amount of exchange-traded options is almost \$65 trillion. *Id.*

14. The BIS estimates the total OTC notional amounts outstanding as almost \$415 trillion. *Id.* at app. 103 (Table 19: Amounts outstanding of over-the-counter (OTC) derivatives).

other. The OTC market consists of many variations on these types of basic derivative contracts: forwards, options, and swaps. The OTC derivative market is divided into five major categories: foreign currency exchange contracts, interest rate contracts, equity-linked contracts, commodity contracts, and credit derivatives.

II. REGULATION OF DERIVATIVES

The present state of derivatives regulation is governed primarily by the Commodity Futures Modernization Act of 2000 (CFMA),¹⁵ which amended the Commodity Exchange Act (CEA).¹⁶ The CEA was enacted in the mid-1930s, contemporaneous with the laws governing securities regulation.¹⁷ Regulation of futures was separate from the securities laws because of the strong agricultural influence in Congress.¹⁸ The primary use of futures in the nineteenth and early twentieth centuries was to ensure stable crop prices by allowing farmers and dealers to enter into pricing contracts that were not subject to the high degree of seasonal volatility that had plagued the agricultural markets.¹⁹ The CEA did not envision the over-the-counter markets for derivatives;²⁰ in fact, it *required* all futures

15. Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified as amended in scattered sections of 7 U.S.C.).

16. Commodity Exchange Act of 1936, ch. 545, 49 Stat. 1491 (codified as amended in scattered sections of 7 U.S.C.).

17. See Securities Act of 1933, 15 U.S.C. § 77(a)-(aa) (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-(o) (2000). The other laws governing the regulation of the securities markets grew out of these laws. See, e.g., Investment Company Act of 1940, 15 U.S.C. § 80(a)(1)-(64) (2000); Investment Advisors Act of 1940, 15 U.S.C. § 80(b)(1)-(21) (2000).

18. See Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom and Japan*, 28 BROOK. J. INT'L L. 319, 338-40 (2003).

19. Prices would skyrocket during the off-season, when the supply of crops was low, but then those prices would plummet after the crops were harvested when the market was flooded with that year's supply. See WILLIAM CRONON, *NATURE'S METROPOLIS: CHICAGO AND THE GREAT WEST* 123-25 (1991). Forwards and futures developed to stabilize these prices for commodities like crops. See CHICAGO BD. OF TRADE, *COMMODITY TRAINING MANUAL* 3-4 (1982).

20. In fact, the enforceability of OTC derivative transactions and swaps was not even certain until the Futures Trading Practices Act (FTPA) of 1992, which amended the Commodity Exchange Act. Pub. L. No. 102-546, 106 Stat. 3590. In the FTPA, Congress provided that transactions by certain "appropriate persons"

contracts to be traded on a “contract market,” such as the Chicago Board of Trade.²¹

In 1974, Congress amended the CEA with the Commodity Futures Trading Commission Act (CFTCA),²² creating a regulatory oversight commission for the futures markets that was similar to the Securities Exchange Commission (SEC). Although the Commodity Futures Trading Commission (CFTC) and SEC struggled over jurisdiction, especially concerning “hybrid” instruments,²³ it was the CFTC that made the move to create a more harmonized regulatory framework for derivative instruments.²⁴ The regulations proposed by the CFTC became the basis for the regulatory framework in the CFMA. Thereafter, the CFTC adopted a revised set of regulations to implement the CFMA.²⁵

(e.g., institutional traders) could be exempt from the exchange trading requirement of the CEA. For a discussion of the exemptive provisions of the FTPA, see Markham, *supra* note 6, at 22.

21. See 7 U.S.C. §§ 6, 6h. For a discussion of the problems created by creating an exchange market monopoly, see Jerry W. Markham, *The Commodity Exchange Monopoly—Reform is Needed*, 48 WASH. & LEE L. REV. 977 (1991).

22. Pub. L. No. 93-463, 88 Stat. 1389 (1974).

23. Hybrid instruments contained elements of futures, options and securities, thus sparking jurisdictional confusion as to who should be able to regulate this market: the SEC or CFTC. For a discussion of these jurisdictional problems, see Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives*, 1990 COLUM. BUS. L. REV. 1 (1990). Further compounding the problem of CFTC regulatory jurisdiction was the Treasury Amendment to the CEA, which stated that the CEA did not govern or apply to an agreement, contract, or transaction in foreign currency; security warrants, security rights, re-sales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sales thereof for future delivery conducted on an organized exchange. 7 U.S.C. § 2(c) (2000). For a discussion of the jurisdictional and interpretative difficulties surrounding the Treasury amendment, see Markham, *supra* note 6, at 17-21.

24. The CFTC proposed regulations that were the prelude to the regulatory framework that Congress adopted in the CFMA, which included exempting swap transactions and creating a tiered regulatory framework. See A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing, 65 Fed. Reg. 77962 (Dec. 13, 2000) (to be codified at 17 C.F.R. pts. 1,5,15,36-38,100,170,180); see also JERRY W. MARKHAM, 13A COMMODITIES REG. § 27:12:1 (2002).

25. A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing, 66 Fed. Reg. 42256 (Aug. 10, 2001) (to be codified at 17 C.F.R. pts. 1,5,15,36-38,40,41,100,170,180).

Congress enacted the CFMA,²⁶ *inter alia*, with these purposes in mind:

- (6) to promote innovation for futures and derivatives and to reduce systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions;
- (7) to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations; and
- (8) to enhance the competitive position of United States financial institutions and financial markets.²⁷

With those guiding purposes in mind, they sought to create a regulatory framework that would allow the innovation of OTC derivative instruments to flourish and not be stifled by excessive regulation that was unnecessary for the sophisticated parties participating in those transactions.

The three themes of flexibility, legal certainty, and shared regulatory coordination run throughout the CFMA.²⁸ The CFMA had two important consequences for derivatives markets: first, it clarified that certain OTC derivative transactions were outside the jurisdiction of the CFTC; and second, it allowed the trading of single-stock futures and futures on narrowly-based stock indices (under joint jurisdiction of the SEC and CFTC).²⁹

The CFMA excludes OTC derivative transactions from

26. The 2000 CFMA established a set of "core principles" that contract markets would have to abide; it was meant to open up competition by eliminating prescriptive rules. *CFTC Reauthorization to Dominate 200: Security Futures, Energy Likely Topics*, 37 Sec. Reg. & L. Rep. (BNA) No. 2, at 72 (Jan. 10, 2005). "Other highlights of the act were the establishment of security futures products and a unique regulatory structure to oversee them, the assurance of legal certainty for derivatives products and a sliding scale of oversight for contract markets that depended on the level of sophistication of the participants." *Id.*

27. CFMA § 2 (Purposes of CFMA).

28. Walt Lukken, CFTC Comm'r, Address at the ISDA Energy, Commodities and Developing Products Conference: The Derivatives World is Flat (June 14, 2006), available at <http://www.cftc.gov/opa/speeches06/opalukken-20.htm>.

29. See Dean Kloner, *The Commodity Futures Modernization Act of 2000*, 29 SEC. REG. L. J. 286, 286 (2001) (explaining the key provisions of the CFMA that apply to the derivatives markets).

regulation as long as the parties are Eligible Contract Participants that are negotiating bilateral contracts for excluded or exempt commodities.³⁰ The CFMA also provides legal certainty for swap agreements,³¹ and specifically states that nothing in the CEA shall apply to "certain swap agreements (including credit and equity swaps), hybrid instruments and other products commonly offered by banks."³² Also, the CFMA provides that futures on single stocks and narrowly based indices are now allowed under joint jurisdiction of the SEC and CFTC.³³ The CFTC remained as the sole regulator of commodity exchanges, having a monopoly over markets in which small traders were allowed to participate in futures and options.³⁴

The effect of these provisions was to provide certainty to OTC derivative transactions and remove them from any regulatory interference as long as "eligible" parties to such contracts abided by the rules in the CFMA. "Market share gradually slipped away to the over-the-counter derivatives markets" because the lack of regulation allowed the OTC market to develop quickly through innovation while the exchange-traded market was stifled by persistent adherence to custom and remained rooted in traditional derivative instruments.³⁵

30. Eligible Contract Participants broadly means that the party must be a large sophisticated institution or a wealthy individual. For a detailed explanation of Eligible Contract Participant, see CFMA, section 101 (Definitions). Excluded commodities are interest rates, exchange rates, currencies, securities, securities indices, credit risks and measures such as inflation and other indices based solely on commodities that have no cash market or on prices or values not within the control of any party to the transaction. Exempt commodities are all commodities that are not "excluded" and not agricultural commodities, such as metals and energy products. See Markham, *supra* note 23.

31. See CFMA, Title III.

32. Kloner, *supra* note 29, at 287.

33. Single stock futures had been prohibited under the Shad-Johnson Accords, an agreement between the SEC and CFTC made in 1982, and later codified by Congress, during the jurisdictional disputes between the two commissions. Pub. L. No. 97-303, 96 stat. 1409 (1982). For a discussion of the Shad-Johnson Accords, see Don L. Horwitz & Jerry W. Markham, *Sunset on the Commodity Futures Trading Commission: Scene II*, 39 BUS. LAW. 67, 72-76 (1983).

34. See Markham, *supra* note 24, at § 28:3.

35. *Id.* The Chicago Board of Trade and the Chicago Mercantile Exchange were once the predominant exchanges for futures, but the Eurex exchange and

There has been tremendous freedom given to the OTC derivative markets, as one report has noted:

It is commonly said that the market in over-the-counter derivatives is unregulated. Compared to the exchange-period derivative market, this is true. The futures and options exchanges operate under the scrutiny of a regulatory agency—the CFTC and the SEC—with broad authority to monitor transactions, to require registration and financial disclosure of market position, to establish and enforce rules of conduct and financial standards, and to intervene directly in the marketplace, if need be, to maintain fair and orderly trading. There is no such overarching regulatory structure in the over-the-counter market.³⁶

This freedom has allowed the OTC derivative market to evolve without strictures.³⁷ In a recent report on credit derivatives, the Government Accountability Office noted:

Because OTC credit derivatives transactions [or any OTC derivative transaction, for that matter] occur between private parties and are not traded on regulated exchanges, they are not subject to regulation in the United States, provided that the parties and other aspects of the transaction satisfy requirements of the Commodity Exchange Although the OTC credit derivatives products themselves are not regulated, certain market participants are. If the dealer is a U.S. bank federally chartered as a national bank, it is supervised by the OCC [Office of the Comptroller of the Currency]. If a bank is owned by a bank holding

even newer exchanges like the Intercontinental Exchange (ICE) were able to undercut the American markets by adopting electronic trading while the CBOT and CME remained steadfastly tied to the trading floors. "Like the American car manufacturers in the 1970s, the exchanges and their members saw their volume being eroded by more nimble competitors, but refused to compete, preferring shelter in their dwindling market share to the risks of competition." *Id.*

36. Markham, *supra* note 6, at 2 n. 6 (citing CONG. RESEARCH SERV., SUBCOMM. ON TELECOMM. & FINANCE OF THE HOUSE COMM. ON ENERGY & COMMERCE, 103D CONG., REP. ON DERIVATIVE FIN. MKTS. 13-17 (Comm. Print 1993)).

37. It is important to note that the OTC derivatives market is not *unregulated*, but rather, "[o]ne of the major reasons behind the exclusion of OTC derivatives from [the CFTC's] jurisdiction was the fact that other Federal regulators were already overseeing many of the entities trading these products." Lukken, *supra* note 28. The sophisticated institutions that deal in OTC derivatives are large banks and firms that are regulated by the Federal Reserve Bank, the SEC and other regulatory agencies; it is only the OTC derivative transactions themselves that do not have a separate regulatory agency.

company, its holding company is regulated by the Federal Reserve. These bank regulators oversee these entities to ensure the safety and soundness of the banking system and the stability of the financial markets. If the credit derivatives dealer is a securities broker-dealer, it is overseen by SEC. According to U.S. regulators, some of the U.S. banks and securities broker-dealers also conduct credit derivatives trades in foreign affiliates subject to foreign regulation. Similarly, other participants in the credit derivatives market include foreign banks that are supervised by foreign regulators and, in some cases, also by U.S. regulators if operating in the United States.³⁸

In the OTC markets, new instruments and products are freely developed to accommodate the varied needs of parties seeking to reduce their exposure to risk, as well as, to make the most efficient use of their resources through the leverage employed by derivative instruments.

One corner of the OTC derivative market has been growing at an astounding rate, and while there have been some bumps in the road, the industry has come together under the watchful eye of regulators to make tremendous strides in solving the problems that such growth has engendered: the credit derivatives market.

III. CREDIT DERIVATIVES

A. *The Credit Derivatives Market*

The credit derivatives market has grown exponentially over the last five years. It has been called “the fastest growing financial market there is.”³⁹ According to the ISDA

38. U.S. GOV'T ACCOUNTABILITY OFFICE, CREDIT DERIVATIVES: CONFIRMATION BACKLOGS INCREASED DEALERS' OPERATIONAL RISK, BUT WERE SUCCESSFULLY ADDRESSED AFTER JOINT REGULATORY ACTION, 10-11 (June 2007), available at <http://www.gao.gov/new.items/d07716.pdf> [hereinafter GAO REPORT]. The GAO was asked by Congress to review the causes of the confirmation backlogs and the steps U.S. financial regulators were taking to address the issue. *Id.* at 2. The GAO analyzed credit derivatives market data, conducted interviews of industry groups, market participants and regulators in Charlotte, N. Carolina; Chicago; New York; and Washington, D.C. from August 2006 to March 2007. *Id.* at 2-3.

39. Jenny Anderson, *Calm Before and During a Storm: Derivatives May Put the New York Fed Chief Through a Stress Test*, N.Y. TIMES, Feb. 9, 2007, at C1 (discussing Federal Reserve Bank of New York president Timothy Geithner,

Year-End 2006 Market Survey, the notional amount outstanding of credit default swaps was \$34.4 trillion at year end, a 101% increase for the year, compared to a 103% increase in 2005.⁴⁰ The notional amount outstanding of credit default swaps was only \$2.15 trillion at the end of 2002.⁴¹ These statistics clearly indicate the phenomenal growth of the credit derivatives market and its increasing importance in the financial world.

One may think of credit derivatives as a form of *performance guarantee*.⁴² Credit derivatives, unsurprisingly, deal with the allocation of credit risk. Credit risk is the risk a party faces that his counterparty will default on their obligation to him.⁴³ Credit derivatives allow a party to “unbundle” credit risk from the other risks that an investment carries.⁴⁴ Credit derivatives are intended to reduce risk by spreading that risk out among many parties.⁴⁵ The credit protection buyer *buys* protection from the protection seller to mitigate, or even eliminate, the risk that a reference entity will default on its obligation to the buyer.⁴⁶ The protection buyer and seller are free to determine what will constitute a “credit event” so as to trigger the obligation of the protection seller to compensate the protection buyer.⁴⁷

and the success of the initiative in the credit derivatives market).

40. INT'L SWAPS & DERIVATIVE ASS'N, INC. 2006 YEAR-END MKT. SURVEY, <http://isda.org> (follow “Surveys & Market Statistics” hyperlink; then follow “Summaries of Market Survey Results” hyperlink). This survey monitors credit default swaps on single-name references, baskets, and portfolios of credit and index trades. Credit default swaps make up the overwhelming majority of credit derivative instrument, see *infra* note 52. Credit default swaps are discussed and explained, *infra*, in the text accompanying notes 52-58.

41. INT'L SWAPS & DERIVATIVE ASS'N, INC. 2002 YEAR-END MKT. SURVEY, available at <http://isda.org> (follow “Surveys & Market Statistics” hyperlink; then follow “Summaries of Market Survey Results” hyperlink).

42. DURBIN, *supra* note 1, at 62.

43. Credit derivatives are usually concerned with debt securities, specifically corporate or sovereign bonds. See *id.*; Feder, *supra* note 2, at 707.

44. For a discussion of the other types of risk, including, market, liquidity, operational, legal and systemic risks, see Feder, *supra* note 2, at 721-31.

45. Anderson, *supra* note 39, at C1.

46. As Durbin points out, this begs the question of how you can be sure that the protection seller will not default. Thus, in reality you have just substituted one credit risk for another. DURBIN, *supra* note 1, at 63 n.1.

47. While the parties are free to determine what will constitute a credit

Credit derivatives are primarily used to:

- Reduce risk from ownership of bonds or loans;
- Take exposure to an entity, as one would do by buying a bond or loan;
- Express a positive or negative credit view on a single entity or a group of entities, independent of any other exposures to the entity one might have.⁴⁸

The idea of reallocating credit risk, or the risk of default, is not new; banks have done it for years when they syndicated loans or took third-party guarantees and letters of credit. The novel aspect of credit derivatives is that they allow for a market in credit risk that is completely separated from the underlying reference obligation, enabling the market to trade the credit risk separately from the instrument that creates the risk.⁴⁹ This allows for much more than just “default protection;” a speculator, confident that the reference entity will not default, can collect a premium as a protection seller, and an arbitrageur or market-maker can find discrepancies in the markets and exploit them by selling credit protection to one party and then buying that same protection from another party at a lower price, or buying low and selling high, and pocketing the difference.⁵⁰

B. *Types of Credit Derivatives*

There are many different types of credit derivatives, and this Comment will only outline a sample to convey the variety of instruments and their uses.⁵¹ First, four of the

event for their transaction, there are five standard credit events defined by the ISDA: bankruptcy, failure to pay, obligation default, obligation acceleration and restructuring. “*Bankruptcy* involves seeking court protection against creditors when a company can’t pay its bills, *failure to pay* is essentially like missing a payment on a car loan, *obligation default* is when the lender declares the borrower in violation of payment terms and demands return of the principal, *obligation acceleration* is when the terms of a debt call for immediate payment of some or all of a debt ‘ahead of schedule’ as a result of some issue, and *restructuring* is a broad event that includes things like debt consolidation.” *Id.* at 65.

48. CRMPG II REPORT, *infra* note 87, at app. A-3.

49. Feder, *supra* note 2, at 707.

50. DURBIN, *supra* note 1, at 62-63.

51. “The diversity of the range of credit derivatives products continues to expand and since the first BBA survey was published in 1996, the market has

basic credit derivatives will be discussed; credit default swaps, total return swaps, credit linked notes and collateralized debt obligations. Then, this author will briefly sketch a few more complex and innovative products being employed in the market today to orient the reader to the intricate nature of these products in the current market.

The most prevalent and simplest type of credit derivative is the *credit default swap* (CDS).⁵² A CDS is like a homeowner's policy—the protection buyer pays a premium (called a CDS spread) to the protection seller, whereby the seller will compensate the buyer for any loss resulting from a “credit event”⁵³ incurred by the reference entity. The primary buyers of single-name CDSs are commercial lenders and corporate or sovereign bond holders, and the primary sellers are insurance companies and large financial institutions.⁵⁴

A CDS can reference a single debt security (e.g. a bond) from a single reference entity, called a *single-name CDS*, or it can reference a portfolio of different debt securities from different reference entities, this is called a *portfolio CDS*. Variations on the CDS include the “first or nth to default,”⁵⁵ the “CDS option,”⁵⁶ an index-linked CDS,⁵⁷ and a “binary

risen exponentially.” Press Release, British Bankers' Ass'n, Credit Derivatives Market Expected to Reach \$33 Trillion by End of 2008 (Sept. 21, 2006) (quoting Ian Mullen, Chief Executive of the BBA).

52. Some authorities estimate that credit default swaps make up ninety-five percent of the credit derivatives market. *Credit Derivatives Market Swells to \$26 Trillion in Year*, Association Says, 38 Sec. Reg. & L. Rep. (BNA) No. 38, at 1590 (Sept. 25, 2006).

53. See *supra* note 47 for an explanation of common credit events.

54. DURBIN, *supra* note 1, at 64. Large financial institutions are often also holders of corporate and sovereign bonds.

55. The “first or nth to default CDS” is a form of portfolio CDS where the protection seller pays the protection buyer when the “first” or “nth” (depending on the terms of the contract) reference entity in the portfolio experiences a credit event. This type of CDS is cheaper than buying a single-name CDS on each reference entity. See Donald A. Bendernagel, *Common Derivatives and Their Uses: Credit Derivatives*, 1559 PLI CORP. 85, 98-101 (2006).

56. In exchange for a premium, the “CDS option” or “Credit Default Swaption” creates the right to buy or sell a CDS on a reference entity in the future at a predetermined price. The buyer would enter into a CDS option if it believes that the cost of a CDS on a reference entity will increase, thereby enabling the buyer to buy protection at a lower price than the market is trading for in the future, allowing the buyer to simultaneously sell protection at the higher market price and pocket the difference (minus the premium paid for the

CDS.”⁵⁸

Another type of credit derivative is the *total return swap*. This allows a protection buyer to “rent out” an asset. The protection seller pays a stream of regular, usually fixed, payments in exchange for the protection buyer transferring all income and capital changes from the reference asset to the protection seller. The protection seller takes all losses and gains incurred by the asset, but the asset remains on the protection buyer’s balance sheet. The main difference between the total return swap and a CDS is that the protection seller makes payments regardless of the performance of the reference asset, rather than compensating the protection buyer for the occurrence of a credit event by the reference entity.⁵⁹

Another form of credit derivative is the *credit linked note*. In this financial vehicle, the protection seller raises capital from investors for the express purpose of issuing credit protection to protection buyers. That capital is held for the sole purpose of providing compensation to credit buyers in the event of a credit event by a reference entity. A “special purpose vehicle” (SPV) or “special purpose entity” is often created to act as the protection seller. The buyer still pays a premium to the seller, but the seller then pays part of that premium to the investors for use of their money. A credit linked note theoretically removes all credit risk for the credit protection buyer *vis a vis* the seller, because the money is being held for the sole purpose of providing credit

option). A seller would take the view that the cost of protection for a reference entity will decrease, thereby locking in that higher price for the cost of the premium. *See id.* at 113.

57. An index linked CDS is an extremely liquid instrument that is like buying a CDS on each reference entity that composes the index all at once. An example is the Dow Jones CDX.IG, which is composed of 125 reference entities. The instrument is so liquid because of the diversity of the entities that compose the index, which enables the index-linked CDS to be an effective hedge for many positions. *See id.* at 112.

58. A “binary CDS” or “digital CDS” is where the protection buyer receives a specified fixed payment from the protection seller upon the occurrence of a credit event by the reference entity, rather than the seller compensating the buyer for the actual loss suffered, or having to pay the buyer par value for the reference obligation. *See* DURBIN, *supra* note 1, at 69; Bendernagel, *supra* note 55, at 114 (describing fixed recovery swaps).

59. This description of a total return swap is based on the explanation provided in DURBIN, *supra* note 1, at 66-68.

protection; thus, theoretically eliminating the risk of default by the seller.⁶⁰

Another form of credit derivative is the *collateralized debt obligation* (CDO). In general, a special purpose vehicle (SPV) is created that issues senior, mezzanine, and sub- (also called equity) debt to raise money to purchase a pool of financial assets, such as debt instruments (this is a cash CDO), or a *group of credit derivatives* (this is a synthetic CDO), or a mixture of the two (a hybrid CDO). The tranches (or levels of debt) each have their own risk rating and level of risk, with the senior tranche having the highest rating and lowest risk, while the equity tranche has the lowest rating and highest degree of risk. The equity tranche incurs all of the losses from the CDO's investments until the equity tranche is exhausted, and then the next lowest tranche will incur the losses, and so on up the hierarchy of tranches. The lower tranches provide a cushion for the higher tranches, ensuring that the higher tranches will not suffer any of the losses of an investment until the lower tranches are exhausted.

The potential return is positively correlated to the risk exposure of each tranche, with the equity getting the highest percentage return on their money, while the senior tranche gets the lowest percentage return. This allows the CDO to leverage its capital because the senior tranche typically invests the majority of the money but is only making a small return, and the lower tranches that are making a higher return have only invested a relatively small amount of the CDO's capital (enough for the CDO to have a comfortable cushion). This allows the CDO to reap a competitive return on its investments that far exceeds the return of the senior tranche, and while this return may be equal to or even lower than the return on the equity tranche, it is calculated on a much higher notional amount, thereby outpacing the return due to the lower tranches. The SPV in the CDO earns the difference in the spread between what it makes on a return for its investments and the aggregate amount of returns it has to pay to the various tranches.⁶¹

60. *Id.* at 68-69.

61. This description of CDOs is summary in nature, for a more comprehensive explanation, see Gary Barnett, *Understanding CDOs*, 891 PLI COMMODITIES 769 (2006); Bendernagel, *supra* note 55, at 102-05.

Hopefully, this sample of basic credit derivatives illustrates the dynamic nature of the market. Credit derivatives offer a variety of ways for parties to custom tailor financial instruments to allocate risk. These instruments serve as the basis for a wide variety of variations on these basic concepts, with new innovations being introduced all the time.

Some innovations are products such as the *target annual review note* (TARN), *constant proportion portfolio insurance* (CPPI), and *constant proportion debt obligations* (CPDO).⁶² These are complex credit derivatives, and are briefly summarized here merely to show the innovation of the market.

In a TARN, capital is invested in a portfolio of positions. The TARN has a target return rate, the achievement of which is the goal of the investment. The TARN promises a 100% protected return of capital investment within a fixed maturity, with an annual coupon based on the worst performing stock in the selected portfolio. But, if the sum of all the coupons in the portfolio reaches the predetermined target return, the TARN is automatically redeemed early. This investment strategy is based on leverage and correlation. The more correlated the positions in the portfolio, the higher the chance of reaching the target return rate, and the greater the chance of an early redemption.⁶³

In CPPI, the investor is theoretically protected against loss, but still able to participate in, and benefit from, gains. CPPI depends on dynamic (or continuous) allocation between risky and non-risky positions (such as government bonds). Capital is allocated to the risky investment as it gains value, but re-allocated to a non-risky investment when the risky position is declining. By shifting more and more money to the non-risky investment during periods of declining value in the risky positions, this strategy seeks to preserve a minimum return (usually a guaranteed return of principal). This strategy depends on high amounts of

62. While the TARN and CPPI investment strategies have been around for a while, they are becoming more prevalent and more widely applied as derivatives markets expand the base of positions to which they can be applied.

63. This description is based on the CRMPG II REPORT, *infra* note 87, at A-38.

leverage to take advantage of the gains in the risky position when it is performing well, as well as constant monitoring of the fluctuations in the underlying position values to determine the proper allocation between risky and non-risky positions.⁶⁴

Another relatively recent innovation in the credit derivatives market is the CPDO.⁶⁵ A special purpose vehicle is created, which issues highly rated bonds (usually AAA for both principal and coupon) to investors with a coupon rate of up to LIBOR + 200bp⁶⁶ (in some cases even higher), with a long maturity date (usually at least 10 years). The SPV then invests that money in a pool of assets, to be used as collateral. The return on that pool of assets is then swapped with a bank in exchange for premiums that the bank pays as a protection buyer in CDSs on a reference portfolio made up of credit indices, usually 50% each of the Dow Jones CDX (Investment Grade) and the iTraxx Europe (IG). These indices are composed of highly rated, stable companies, and the indices are rolled (i.e., rebalanced to determine which companies to include in the index) every six months—this leads to a relatively low risk of default on the CDSs because the index is monitoring the credit worthiness of the companies it lists.

The CPDO starts out highly leveraged (up to 15x) to build up a cushion between its investment returns (i.e., the premiums collected as protection sellers in the CDSs) and its coupon payments. Leverage is then decreased over time if the investments perform well, or maintained at a high rate if necessary to make up for any poor performance or

64. This description is based on *id.* at A-39. See also bfinance, Constant Proportion Portfolio Insurance (CPPI) 101, <http://www.bfinance.co.uk/inst/article.do?serieId=1&docid=N12309> (last visited Feb. 20, 2007).

65. This is a type of structured credit product introduced in 2006; it is discussed briefly to show the constant innovation in the credit derivatives market. See Paul Davies, *Questions lie behind CPDO hype: The new kid on the block has made a big impact, but investors should take a long look before they leap*, FIN. TIMES, Nov. 14, 2006, at 43 (discussing the impact of CPDOs on the credit market). Such innovation is a constant attempt to more efficiently allocate risk, and may not be possible if the market was directly regulated, as discussed *infra*.

66. LIBOR refers to the London Inter Bank Offer Rate, an interest rate that is published daily and commonly used as a reference rate in derivatives and other financial instruments. And, "bp" refers to basis point, i.e., 1/100th of a percent.

defaults. A reserve is built up that will be used as a cushion for any future defaults and to pay back principal at the maturity date. This investment product has a high rating, but is not guaranteed—the initial investor is really taking an equity position in exchange for its principal investment, but in a strategy that has been modeled and supposedly tested to ensure a relatively high degree of certainty of payment of coupon and principal.⁶⁷

These brief discussions of basic types of credit derivatives and the more current complex adaptations are meant only as a broad overview, to convey the complexity and constant innovation of the credit derivatives market. The product descriptions were brief and summary in nature, not delving into many of the subtleties and intricacies that underlie these instruments, and were offered to establish a context in which to place the recent market developments.

As a final introductory note concerning credit derivatives, it is important to mention that credit derivatives can be settled in two ways: physical settlement and cash settlement. Upon the occurrence of a credit event that obligates the seller to compensate the buyer, physical settlement involves the credit protection buyer delivering to the protection seller the underlying reference obligation, in exchange for the par value of the reference obligation. For cash settlement, the protection seller merely compensates the buyer for the buyer's net loss from the credit event by the reference entity. This is a simple form of *netting*, a concept which will be discussed *infra*, in the context of netting multiple transactions between parties.

67. This brief discussion of CPDOs in the preceding two paragraphs relied on information found at: CITIGROUP, CORPORATE AND INVESTMENT BANKING, CPDOs THE NEW BEST SELLER? (Nov. 10, 2006) available at http://www.nuclearphynance.com/User%20Files/464/Citi_cpdos%20-%20the%20new%20best%20seller.pdf (giving a comprehensive discussion of CPDOs); Davies, *supra* note 65, at 43 (giving a brief description of CPDO mechanics). However, there has been some controversy regarding the AAA ratings that some CPDOs, especially early ones, received from ratings agencies. See Paul J. Davies, *Fitch Criticizes Ratings of CPDOs*, FIN. TIMES, Apr. 18, 2007, at 39.

IV. THE RECENT DEVELOPMENTS IN THE CREDIT DERIVATIVES MARKET

As mentioned above, the credit derivatives market has been developing very quickly over a relatively short period of time.⁶⁸ This Comment will focus on the recent industry initiatives that have helped shape that market during 2005-2006, focusing on the fourteen dealers who, through a collective initiative, collaborated under the supervision of the Federal Reserve Bank of New York and other regulators, to solve the problems facing the market in 2005. Additionally, in Part VI, this industry initiative will then be discussed as a potential model for the future of U.S. regulation.

In February 2005, the Financial Services Authority⁶⁹ (FSA) issued a letter "to all financial institutions that are active in the credit derivatives market,"⁷⁰ calling attention to the widespread "level of unsigned confirmations^[71] with some transactions remaining unconfirmed for months."⁷²

68. See text accompanying *supra* notes 39-41.

69. The FSA is the United Kingdom financial markets' regulatory body, it "is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act of 2000 The FSA is accountable to the Treasury Ministers, and through them to Parliament. It is operationally independent of Government, and is funded entirely by the firms it regulates. See Fin. Servs. Auth., *Who are we*, <http://www.fsa.gov.uk/Pages/About/Who/index.shtml> (last visited Feb. 1, 2007).

70. Letter from Gay Huey Evans, Dir., Mkt. Servs. Div., Fin. Servs. Auth., to CEOs (Feb. 2005), *available at* http://www.fsa.gov.uk/pubs/ceo/derivatives_22feb05.pdf [hereinafter FSA Letter].

71. "A confirmation sets out the terms and conditions of a credit derivative transaction While the economic terms of the transactions can be agreed upon upfront, confirmation problems can be traced back to a number of non-economic, technical issues." *N.Y. Fed Said Pleased With Banks' Plan To Address Key Credit Derivatives Issues*, 37 Sec. Reg. & L. Rep. (BNA) No. 40, at 1682 (Oct. 10, 2005). "Confirmations serve as an internal control to verify that both parties agree to the trade terms and have accurately recorded the trade in their systems. For this reason, trades should be confirmed as soon as possible." GAO REPORT, *supra* note 38, at 15. "Though transactions become legally binding once agreed to over the telephone, regulators are concerned that the backlog of confirmations would become an operational nightmare if credit markets were rocked by, for example, a series of corporate defaults." *N.Y. Fed Hails Banks' Progress In addressing Credit Derivatives Issues*, 37 Sec. Reg. & L. Rep. No. 41, at 1713 (Oct. 17, 2005).

72. FSA Letter, *supra* note 70.

The FSA recognized that credit derivatives provided a number of benefits, including as a tool for diversifying risk and a method for bringing increased liquidity to all segments of the credit market, but was concerned that operational deficiencies could have a potentially devastating impact on the global market through the misunderstandings and uncertainty that arise from unconfirmed transactions.⁷³

The FSA asked that individual firms consider their “operational processes and risk management frameworks—and the resourcing of these in relation to credit derivatives—to assess their robustness in this rapidly evolving market. . . . And more specifically [make sure that] the necessary steps are in place to tackle the level of outstanding confirmations in credit derivatives.”⁷⁴ These backlogs were the result of the rapidly growing volume of trading, and the inefficient manual confirmation processes and difficulties in confirming a trade that may have been unilaterally assigned to another party.⁷⁵ The average number of trades at the largest dealers increased from 644 trades per week in 2004 to 1,450 trades per week in 2005.⁷⁶ By the end of September 2005, among the fourteen largest credit derivatives dealers, there were over 150,000 unconfirmed trades, with nearly two-thirds remaining unconfirmed for more than thirty days.⁷⁷

A few weeks after the FSA letter, the Joint Forum⁷⁸

73. *Id.*; see also Press Release, Fin. Servs. Auth., FSA Warns Firms on OTC Credit Derivatives Administration (Feb. 22, 2005), available at <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2005/022.shtml>.

74. FSA Letter, *supra* note 70.

75. Confirmations take place in the “back office,” where the trades were recorded, verified and confirmed through largely manual processes. In contrast, the “front office” is where the traders and sales staff execute the deal by interacting with the customer. GAO REPORT, *supra* note 38, at 8.

76. *Id.* at 11.

77. *Id.* at 3.

78. “The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency.” Bank for Int’l Settlements, Joint Forum, <http://www.bis.org/bcbis/>

issued a report, by its Working Group on Risk Assessment and Capital, on Credit Risk Transfer activity.⁷⁹ This report contained seventeen recommendations to improve the present state of credit risk transfer (CRT) activity, “focus[ing] more narrowly on the newest forms of CRT, in particular on those activities associated with credit derivatives.”⁸⁰ This report had several suggestions aimed directly at improving the credit derivatives market, but also acknowledged the “willingness of market participants to address such issues prior to specific regulatory pressures to do so, as well as the existence of effective mechanisms to undertake such collective efforts.”⁸¹

The report identified four main issues in the credit derivatives market: (1) counterparty credit risk; (2) legal uncertainty; (3) timely matching and confirmations; and (4) what can broadly be characterized as model risk.⁸² The Joint Forum Report recommended that parties to credit derivative transactions take every effort to ensure that they are adequately assessing the risks posed by such transactions, including establishing the credit worthiness of counterparties, and assessing their aggregate risk to individual market participants.⁸³ Other factors to consider were whether the risk models used by market participants were adequately assessing factors such as correlation and

jointforum.htm (last visited Feb. 1, 2007).

79. JOINT FORUM, CREDIT RISK TRANSFER (Mar. 2005), available at <http://www.bis.org/publ/joint13.pdf> [hereinafter JOINT FORUM REPORT]. It should be noted here, that while the JOINT FORUM REPORT was published in March 2005, it was circulated for comment in October 2004, and was cited as a motivating force behind the FSA Letter urging the credit derivatives market to take action to improve its infrastructure. *Id.* at 1; FSA Letter, *supra* note 70.

80. JOINT FORUM REPORT, *supra* note 79, at 1.

81. *Id.* at 16 (pointing out issues where the market has taken upon itself to address perceived vulnerabilities: creating a database for CDS reference entity names, developing services to support matching and confirmation, development of standardized documents, and development of voluntary standards for appropriate use of non-public information).

82. *Id.* at 2-3.

83. *Id.* at 25-29 (stressing the importance of parties conducting their own assessment of parties credit worthiness and not simply relying on external rating services, emphasizing that ratings across different types of investments do not necessarily correspond, i.e., a AAA rating for a bond differs in risk profile from a AAA rating for a credit default swap).

adequacy of collateral posted for transactions.⁸⁴

The Joint Forum Report also provided recommendations for improving legal certainty by stepping up efforts in standardization of documentation and increased automation, as well as being particularly careful with how parties handle confidential non-public information.⁸⁵ The Joint Forum also echoed the concern of the FSA in the level of unsigned confirmations for transactions in the credit derivatives market, recommending greater implementation of automation in the confirmation process to address this issue. The report also commented on the issue of the practice of undocumented assignment of existing contracts to third-parties without the consent of the original counterparty.

In general, the report offered the above recommendations for the credit derivatives market, as well as the broader credit market recommendation that participants perform more comprehensive stress testing and scenario analysis; to take into account possible unfavorable changes in the currently benign market structure, focusing on the high concentration of risk in a relatively few number of market participants and the correlative effects that one such participant's default would have on the market as a whole, and the effects particular to each participant's aggregate risk exposure to that defaulting party.⁸⁶

84. Firms should dynamically (i.e., constantly) reassess the amount of collateral required for a transaction, and not simply rely on a one-time calculation. Also, parties need to assess the correlative effects across their aggregate transactions, the possible correlations between the protection seller and reference entity, and the possible change in liquidity of contracts, especially complex products, in the face of a default by a major market participant. *Id.* at 29-30.

85. *Id.* at 31-34. The report highlighted problems associated with corporate and debt restructuring, and the effect on corresponding credit derivative reference obligations. It also pointed out the need for greater standardization in documentation to eliminate uncertainty and misunderstandings, especially as products become more complex. The report applauded ISDA for its part in creating many of the current standardized documents in the market, and encouraged the ISDA to continue its efforts in this area.

86. *Id.* at 35-36. Other general recommendations included ensuring that market participants employ sufficient personnel to deal with the increasing complexity of the credit markets, and the need for supervisors and management to take an active role in ensuring the adequacy of their entity's risk management program.

In July 2005, another report highlighted critical deficiencies in the credit derivatives market infrastructure: the Counterparty Risk Management Policy Group II (CRMPG II) Report.⁸⁷ The CRMPG II Report was a *private sector initiative* that voluntarily took action to provide a framework for financial stability. This report issued 47 Guiding Principles and Recommendations⁸⁸ that should be used as a framework for anticipating, preparing for and preventing potential financial shocks to the global financial markets in this era of increasing complexity. Many of these principles and recommendations are applicable to the credit derivatives market, and some are specifically addressed to that audience.

One of the major issues in the credit derivatives market identified in the CRMPG II Report was the backlog of confirmations.⁸⁹ The CRMPG II called for an industry-wide meeting to address this problem:

CRMPG II endorses the convening of an industry-wide roundtable in the near term to focus on aggressively reducing confirmation backlogs by working toward further technological and operational

87. COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (July 27, 2005), available at <http://www.crmpolicygroup.org/> [hereinafter CRMPG II REPORT].

On January 15, 2005, the organizational meeting of the Counterparty Risk Management Policy Group II (CRMPG II) was held in New York. CRMPG II is comprised of senior officials from major financial institutions and is chaired by E. Gerald Corrigan, Managing Director, Goldman Sachs [and former NY Fed president] The primary purpose of CRMPG II—building on the 1999 report of CRMPG I—is to examine what additional steps should be taken by the private sector to promote the efficiency, effectiveness and stability of the global financial system.

Id. at 1. The CRMPG I report issued in 1999 had similar objectives: improving on “(i) counterparty credit assessment, (ii) risk management, measurement and reporting, (iii) market practices, and (iv) conventions and regulatory reporting.” Zdenka Seiner Griswold, *Counterparty Risk Management Policy Group II: OTC Documentation Practices in a Changing Risk Environment*, in BROKER-DEALER REG. 177, 179 (ALI-ABA ed., 2006) (offering a comprehensive discussion of the CRMPG II REPORT, particularly as it relates to the OTC derivatives markets).

88. CRMPG II REPORT, *supra* note 87, at 13-40 (listing the 47 Guiding Principles and Recommendations).

89. *Id.* at 74-76.

enhancements, and by strengthening backoffice operations.⁹⁰

The CRMPG II recommended further development of automated trade processing and matching, such as electronic trade platforms, with the ultimate goal of "straight through processing," as the best way to achieve increased efficiency in the market.⁹¹ Another major issue was netting. This is the process of settling transactions between parties by allowing off-setting obligations to cancel each other out: theoretically leading to a single payment from one party to its counterparty, regardless of the number of transactions between them. The CRMPG II Report recommended increased use of netting across like-kind obligations, cross-product obligations, across master agreements, and in collateral arrangements whenever the parties are certain of its legal enforceability.⁹²

The CRMPG also applauded the efforts that the derivatives markets have made in standardization of

90. *Id.* at 75.

91. *See id.* at 77-84, which discusses some of the automated trade matching and processing platforms available in the market, including DTCC (discussed *infra* notes 111-13 and accompanying text), eConfirm, SwapClear, and Swapwire, and the benefits of these developing market innovations. The ultimate goal for the market should be straight through processing, which would "reduce[]the number and frequency of trade disputes and maximizes market efficiency, opportunity and access. STP therefore fosters legal, credit, market and operational certainty." *Id.* at 84. Straight through processing has been the goal for many markets seeking to eliminate the need for human intervention in processing orders and confirmations, thereby expediting and reducing the possibility of mistakes in the process.

92. The CRMPG II cited approvingly the available netting possibilities in the DTCC and SwapClear, as well as the netting approach available in the IFXCO Master Agreement, the close out valuation methods in the ISDA Master Agreements of 1992 and 2002, the ISDA Bridge Agreement, Bond Market Association's Cross-Product Master Agreements, and the legal opinions gathered by the ISDA in many jurisdictions, confirming the enforceability of its Bridge Agreement. *See id.* at 85-95. The IFXCO Master Agreement governs foreign exchange and currency derivatives. *Id.* The close out valuation methods in the 1992 ISDA Master Agreement (Market Quotation and Loss) and the method in the ISDA 2002 Master Agreement (Close-out Amount) provide for netting obligations under a single master agreement. *Id.* The ISDA Bridge and Bond Market Association Cross-Product Master Agreements provide for netting of obligations across more than master agreement. *Id.* The CRMPG II also applauded the efforts of many jurisdictions, including in the U.S. Bankruptcy Code and U.S. bank insolvency laws, for their efforts to adopt legislation consistent with netting enforcement. *Id.* at 93-94.

documents and definitions, thanks in large part to the efforts of the ISDA, but emphasized the need for further progress in this area for greater legal and systemic certainty, as well as a necessary step in the furtherance of developing a greater degree of automation.⁹³

Other specific issues regarding credit derivatives included many of the same concerns voiced by the Joint Forum, including: concern over the practice of assigning trades without consent,⁹⁴ potential failures in properly assessing counterparty credit risk,⁹⁵ possibility of unknown correlations in the market,⁹⁶ and legal risks that could be better avoided through greater standardization of documentation, with the ultimate goal of straight through processing.⁹⁷

The CRMPG II Report has one central theme: increasing complexity,⁹⁸ which gives rise to the necessity for increased vigilance in monitoring and evaluation of risk management procedures, and overall policies through improved stress testing, scenario analysis and modeling of risk.⁹⁹ The CRMPG II Report was a foundational undertaking by the private sector that paved the way for the progress made by the credit derivatives market under the guidance of the Federal Reserve Bank of New York (NY Fed).

The CRMPG II called for an immediate "industry-wide roundtable . . . to focus on aggressively reducing confirmation backlogs."¹⁰⁰ The NY Fed was quick to respond, sending a letter to fourteen key Wall Street firms on August 12, 2005, calling for such a meeting "to discuss how best to address a range of important issues in the credit derivatives market."¹⁰¹ That meeting took place at

93. *Id.* at 101-05 (focusing especially on harmonization of documents for cross-agreement application).

94. *Id.* at 115-16.

95. *Id.* at 110-12.

96. *Id.*

97. *Id.*

98. *Id.* at 10.

99. *Id.* at § V.

100. *See supra* note 92 and accompanying text.

101. *N.Y. Fed Invites Wall Street Firms to Discuss Use of Credit Derivatives*,

the NY Fed on September 15, 2005, focusing on the issues in the credit derivatives market “with regard to assignments of trades and operational issues associated with confirmation backlogs.”¹⁰² Fourteen industry participants took part in the meeting, along with fifteen supervising/regulatory entities also in attendance.¹⁰³ “The industry participants outlined a number of concrete steps to achieve [the] goals.”¹⁰⁴

On October 4, 2005, the fourteen industry participants (referring to themselves as the “Major Dealers”)¹⁰⁵ sent a letter to the NY Fed, outlining their collective progress and giving an update on the “next steps toward improving Credit Derivatives industry practices and confirmation backlogs.”¹⁰⁶ The Major Dealers stated that they had met

37 Sec. Reg. & L. Rep. (BNA) No. 35, at 1450 (Aug. 29, 2005) (quoting N.Y. Fed. Reserve Bank President, Timothy Geithner); see Riva D. Atlas, *Fed Officials Summon Wall Street Firms to Discuss Derivatives*, N.Y. TIMES, Aug. 25, 2005, at C5; Henny Sender, Michael Mackenzie & Ramez Mikdashi, *Fed, Banks Will Meet Over Derivatives*, WALL ST. J., Aug. 25, 2005, at C3.

102. Press Release, Fed. Reserve Bank of N.Y., Statement Regarding Meeting on Credit Derivatives, (Sept. 15, 2005), available at <http://www.newyorkfed.org/newsevents/news/markets/2005/an050915.html>; see also Riva D. Atlas, *Trying to Put Some Reins on Derivatives*, N.Y. TIMES, Sept. 16, 2005, at C7 (quoting one banker who attended the meeting but wished to remain anonymous as saying “[r]egulators wanted to get everyone together to make sure the industry knew they were concerned. It was left to the industry to come back with solutions.”); Henry Sender, *Credit Derivatives and Their Risks are on the Table*, WALL ST. J., Sept. 15, 2005, at C1 (quoting Thomas Russo, Vice Chairman of Lehman Brothers Holdings, Inc., as referring to the issues of market infrastructure discussed at the meeting as the “plumbing of the market”); N.Y. Fed, *Wall Street Firms Mull Thorny Credit Derivatives Issues*, 37 Sec. Reg. & L. Rep. (BNA) No. 37, at 1527 (Sept. 19, 2005).

103. For a list of the industry participants and regulatory entities in attendance, see Fed. Reserve Bank of N.Y., List of Attendees, <http://www.newyorkfed.org/newsevents/news/markets/2005/DerivativesParticipants.doc> (last visited Feb. 2, 2007). Many of these participants were also involved in CRMPG II.

104. Statement Regarding Meeting on Credit Derivatives, *supra* note 102; see also *Wall Street Firms to Submit Plan to Shrink Confirmation Backlog*, 37 Sec. Reg. & L. Rep. (BNA) No. 39, at 1632 (Oct. 3, 2005) (stating that the next step in the process would be a plan in the form of a letter from the market participants which would be released in early Oct. 2005).

105. Also known as the “Fed 14.” See, e.g., *New York Fed’s Geithner Urges Care in Use of Credit Derivatives*, 38 Sec. Reg. & L. Rep. No. 21, at 882 (May 22, 2006).

106. Letter from Senior Mgmt. of the Fourteen Indus. Participants, to Timothy Geithner, Pres. of Fed. Reserve Bank of N.Y. (Oct. 4, 2005), available

regularly since the Sept. 15, 2005 meeting at the NY Fed, and had established an initial framework for improving the infrastructure of the market by:

- committing to provide monthly metrics;¹⁰⁷
- committing to implement and adhere to the ISDA 2005 Novation Protocol,¹⁰⁸ to provide proper procedure for

at

<http://www.newyorkfed.org/newsevents/news/markets/2005/industryletter.pdf> [hereinafter First Industry Letter]; see also *N.Y. Fed Said Pleased with Banks' Plan to Address Key Credit Derivatives Issues*, *supra* note 71, at 1682 (summarizing the issues discussed in the letter); *N.Y. Fed Hails Banks' Progress in Addressing Credit Derivatives Issues*, 37 Sec. Reg. & L. Rep. (BNA) No. 41, at 1713 (Oct. 17, 2005) (further discussing the content of the letter).

107. First Industry Letter, *supra* note 106.

To enable the regulators to monitor the dealers' progress as part of the joint regulatory initiative, the 14 dealers agreed to collect data on their credit derivatives activities, including trading volume, unconfirmed trades, and trades confirmed using automated systems. Under the agreement, the dealers provide their individual data to Markit Group, a provider of independent data, portfolio valuations, and OTC derivatives trade processing. In turn, Markit Group aggregates the data across the dealers to protect the confidentiality of each dealer's data and then provides the regulators with aggregate data in a monthly report.

GAO REPORT, *supra* note 38, at 20.

108. The ISDA 2005 Novation Protocol amends the ISDA Master Agreements to allow for the transfer of an obligation or interest under the requires Agreement without written consent of the Remaining Party (i.e., email and fax consent is satisfactory). INT'L SWAPS & DERIVATIVES ASS'N, 2005 NOVATION PROTOCOL, (published Sept. 12 2005), available at <http://isda.org> (follow "ISDA Protocols" hyperlink; then follow "2005 Novation Protocol" hyperlink; then follow "2005 Novation Protocol Text and Form of Adherence Letter" hyperlink; then follow "here" hyperlink for text). All adhering parties, when in the position of Transferor, are required to obtain consent from the Remaining Party on the day of proposed novation, and provide detail sufficient to identify the transaction being transferred, and upon consent of the Remaining Party, provide notice of that consent to the Transferee. *Id.* at Annex 1. When in the position of the Remaining Party, adhering parties may withhold consent to a novation for any reason, but must provide notice of whether it consents to the Transferor by 6:00 p.m. on the day of the novation. *Id.* When in the position of Transferee, upon notice of consent by the Remaining Party it must confirm all relevant details of the transaction being transferred. *Id.* If consent is not provided by the Remaining Party, the rights and obligations vis a vis the Transferor and Transferee are still in effect, but the Transferor effectively becomes a "pass-through" and acts as a conduit whereby the obligations of the Transferee and Remaining Party flow through the Transferor, but Transferor remains as counterparty to both, rather than stepping out of the transaction and allowing the Remaining Party and Transferee to become

- assigning trades to third-parties;¹⁰⁹
- establishing target dates and levels by which to aggressively reduce confirmation backlogs by putting in place appropriate procedures and policies to achieve the reduction;¹¹⁰
- committing to move the industry, over time, to a T + 5 standard for vanilla confirmations;¹¹¹
- committing to fully use the DTCC¹¹² in its existing

counterparties. *Id.* All novations will be documented by all parties entering into a Novation Confirmation as soon as practicable after the novation. *Id.*; see also Guide to Implementation of the 2005 ISDA Novation Protocol, available at <http://isda.org> (follow “ISDA Protocols” hyperlink; then follow “2005 Novation Protocol” hyperlink; then follow “Guide to the Implementation of the 2005 Novation Protocol” hyperlink) (offering a comprehensive explanation of the novation terms in the Protocol).

109. First Industry Letter, *supra* note 106. The Major Dealers committed to setting an effective date for the ISDA 2005 Novation Protocol of October 24, 2005, and finalizing a Guide to support implementation of that Protocol. *Id.* The highlights of the Guide include: (1) obligation of the transferor to obtain written consent from the remaining Party on the novation trade date; and (2) a process for notification and method for communication. *Id.* A novation is “[t]he act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party.” BLACK’S LAW DICTIONARY 1094 (8th ed. 2004). In this context, it deals with one counterparty assigning its obligation to a contract to another party, often without informing or getting the consent from its original counterparty.

110. The Major Dealers committed to make significant progress on the reduction of their backlogs. First Industry Letter, *supra* note 106. (“The Major Dealers commit that by January 31, 2006, we will each reduce our number of confirmations outstanding more than 30 days by 30% from our number of confirmations outstanding more than 30 days as of September 30, 2005 The Major Dealers commit to set a further aggressive target for March 31, 2006. We will finalize this target by December 15, 2005, when we expect to have substantial knowledge of the impacts of automation advances, lock-ins, and the Novation Protocol.”)

111. The ultimate goal will be moving the industry to a standard of all vanilla (plain or simple) confirmations taking place within five days after the trade or transaction and to “dramatically increase utilization of automated matching through DTCC and to change the current market practices on novations [which] will lay the foundation for moving to that standard, which will be met through high levels of automated processing.” *Id.*

112. The Depository Trust & Clearing Corporation (DTCC) provides electronic clearance, settlement and information services for a wide range of derivative products, including OTC derivatives. DTCC, *About DTCC: An Overview*, <http://www.dtcc.com/about/business/index.php> (last visited Oct. 5, 2007). DTCC Deriv/Serv is a matching and settlement service that provides for payment netting and settlement, and can accommodate virtually all standard credit default swap transactions; it has gained wide industry acceptance globally and is partnered with the Reference Entity Data (RED) service. DTCC, *DTCC Deriv/Serv*, <http://www.dtcc.com/ProductsAndServices/derivserv/>

functionality, and requiring all active clients to subscribe to industry-accepted electronic trading platforms;¹¹³

- continuing to encourage all clients to sign up with DTCC;¹¹⁴
- continuing to refine the cash settlement process for integration into master confirmations for North American index contracts; and using protocols and the auction process in the event of any credit events in the interim;¹¹⁵ and
- active use of the “tear up” process to reduce open trades in distressed names.¹¹⁶

The Major Dealers followed their first letter with a second in December 2005, again reporting their progress and setting a second target date and level for reduction of

index.htm (last visited Feb. 3, 2007).

113. The Major Dealers committed to fully using DTCC existing functionality by October 31, 2005. It will also requires all active clients to subscribe to DTCC or alternative industry accepted electronic matching platforms, by January 15, 2006, and require all clients who trade on average one time per week over the prior three months to subscribe to subscribe and use DTCC by March 31, 2006. First Industry Letter, *supra* note 106.

114. *Id.*

115. The Major Dealers worked with the ISDA to complete the Delta & Northwest CDS Index Protocol to deal with the settlement of contracts to which Delta and Northwest were reference entities after the two airlines filed for bankruptcy. Thanks in large part to the efforts of the ISDA and industry participants, the obligations of Delta and Northwest were settled without the chaos predicted by some in the face of a large reference entity default. See e.g. *Geithner Says Credit Derivatives Bolster Financial System Stability*, 38 Sec. Reg. & L. Rep. (BNA) No. 12, at 479 (Mar. 20, 2006) (stating “[a] critical issue going forward for the dealers involves establishing policies, procedures, and documentation for settlement of credit default swaps in the aftermath of a default by a reference entity.”). The Major Dealers pledge to keep working with the ISDA to refine the *ad hoc* protocol process for settlement of defaulting entity obligations. The ISDA has subsequently developed protocols to deal with the defaults of Delphi, Dura, Dana, and Calpine. See ISDA, ISDA Protocols, <http://isda.org> (follow “ISDA Protocols” hyperlink) (last visited Oct. 18, 2007). The Major Dealers also formed a working group to further integrate cash settlement processes for North American index contracts by March 2006, the next index roll (a process in which indices change the composition of their members to ensure that the index remains representative of the most liquid entities; usually takes place every six months). First Industry Letter, *supra* note 106.

116. The Major Dealers scheduled an industry tear-up on October 7, 2005. First Industry Letter, *supra* note 106. For a description of a “tear-up,” see *infra* note 138.

outstanding confirmations.¹¹⁷

Another meeting of the Major Dealers at the NY Fed was scheduled for February 16, 2006, to discuss the progress on the commitments outlined in the two letters.¹¹⁸ After that February meeting, the NY Fed announced that it was encouraged by the progress that the Major Dealers had made in fulfilling the commitments outlined in their first letter, and their commitment to continue working together on those issues.¹¹⁹ The Major Dealers had exceeded their target level of 30% reduction in unconfirmed trades for January, and as a whole had achieved a 54% reduction.¹²⁰ The Major Dealers had also adhered to the ISDA 2005 Novation Protocol for the assigning of trades, and increased use of electronic trade processing from 46% in September 2005 to 62% by January 2006.¹²¹ The NY Fed was quoted as saying, “the industry group is committed to continue making progress in these areas and . . . will outline a set of conditions that would define acceptable market practices for post-trade processing.”¹²²

Following the February meeting at the NY Fed, the

117. Letter from Senior Mgmt. of the Fourteen Indus. Participants, to Timothy Geithner, Pres. of Fed. Reserve Bank of N.Y. (Dec. 16, 2005), *available at* <http://newyorkfed.org/newsevents/news/markets/2006/industryletter.pdf> [hereinafter Second Industry Letter]. The Major Dealers committed to reducing outstanding confirmations of more than thirty days by 50% from the September 30, 2005 number of confirmations outstanding more than thirty days by April 30, 2006. *Id.*

118. Press Release, Fed. Reserve Bank of N.Y., February 16 Meeting on Credit Derivatives (Jan. 12, 2006), *available at* <http://newyorkfed.org/newsevents/news/markets/2006/an060112.html>.

119. Press Release, Fed. Reserve Bank of N.Y., Statement Regarding Progress in Credit Derivatives Markets (Feb. 16, 2006), *available at* <http://newyorkfed.org/newsevents/news/markets/2006/an060216.html>.

120. *Id.*

121. *Id.*

122. *N.Y. Fed Pleased by Banks' Progress in Addressing Credit Derivatives Targets*, 38 Sec. Reg. & L. Rep. (BNA) No. 9, at 322 (Feb. 27, 2006); *see also* Henry Sender, *Concerns Dog Credit Derivatives—Industry Group Symposium Explores Market Imbalances Bankruptcies May Trigger*, WALL ST. J., Mar. 1, 2006, at C3 (discussing the progress made in the credit derivatives market since the first Major Dealer meeting, but recognizing that there is still work to be done, especially with regard to issues such as stress testing and scenario analysis which need to take into account the possible strain caused by the exit of a major player in the credit derivatives market which has a concentrated dealer base).

Major Dealers sent a third letter to the NY Fed.¹²³ They outlined further steps they were planning to take to improve the infrastructure of the credit derivatives markets:

- moving towards a largely electronic market place;¹²⁴
- developing standard industry timelines for affirmation and confirmation of trades;¹²⁵
- developing an “industry trade warehouse;”¹²⁶
- developing new procedures for settlement following a

123. Letter from Senior Mgmt. of the Fourteen Indus. Participants, to Timothy Geithner, Pres. of Fed. Reserve Bank of N.Y. (Mar. 10, 2006), *available at* <http://newyorkfed.org/newsevents/news/markets/2006/industryletter2.pdf> [hereinafter Third Industry Letter].

124. The Major Dealers committed to implementing industry wide best practice guidelines, which include processing electronically all trades that are so capable of being processed (called Eligible Trades), with straight through processing as the ultimate industry goal. *Id.*; *see also Credit Derivatives Dealers Issue New Set Of Commitments For Industry improvement*, 38 Sec. Reg. & L. Rep. (BNA) No. 12, at 479 (Mar. 20, 2006) (quoting Corrigan, former NY Fed chairman and organizer of CRMPG II, as saying that “fully automated, or ‘straight through,’ trade processing that would require virtually no human intervention is a key long term industry goal.”).

125. “Details of Eligible Trades should be submitted to the relevant Electronic Platform no later than T + 1 business day and matched/affirmed (and any rejections/exceptions/discrepancies resolved) no later than T + 5 business days. Confirmation for non-Eligible Trades should be issued no later than T + 10 calendar days.” Third Industry Letter, *supra* note 123. All trades should be confirmed (or resolved) no later than T + 30 calendar days. *Id.*

126. The Major Dealers were working with DTCC to create “a central trade information warehouse for credit derivatives—essentially a comprehensive database containing the ‘golden copy’ of each contract—and a central support infrastructure that standardizes and automates downstream processes throughout the life of each contract.” *Id.* The DTCC Deriv/Serv Trade Information Warehouse was launched in September 2006. *See DTCC Deriv/Serv, Trade Information Warehouse: A Practical Guide for the Buy Side*, <http://derivserv.dtcc.com/binary/31182A%20Practical%20Guide-%20Release10-06.pdf> (last visited Feb. 3, 2007) (a comprehensive description of the services provided by Deriv/Serv and the Trade Information Warehouse). “The initial Warehouse Eligible Transactions will be single name CDS (both corporate and Sovereign using master confirmation agreements, default master confirmation agreements or the ISDA physical settlement matrix), CDS Index products, and Tranched index products, all being confirmable through Deriv/SERV confirmation services as of June 1, 2006.” BOND MKT. ASS’N, THE ASSET MANAGERS FORUM WEEKLY REP., *AMD Speaks on CDS Automation*, Sept. 22, 2006, *available at* <http://www.theassetmanager.com/WeeklyReport/092206.html> (discussing the DTCC Trade Information Warehouse); *see also Clearing the Derivatives Backlog*, DIALOGUE, THE VOICE OF THE SWIFT CMTY. (Q2 2006), at 22.

- credit event;¹²⁷ and
- further reduction in unconfirmed confirmations.¹²⁸

The Major Dealers pledged “[o]ngoing [c]ommitment to [m]aintaining [i]ndustry [m]omentum,” recognizing that “[w]e may find that a tactical step that we think will solve the problem today may not, without modification, get us all the way to the steady state,”¹²⁹ highlighting the flexible nature of the initiative, which allows the market to self-correct and “self-regulate” (an integral element of the regulatory model advocated in this Comment in Part VI).

The NY Fed was again “encouraged by the cooperation and progress made to date.”¹³⁰ At a meeting in Washington in June 2006, Federal Reserve Board Governor Susan Schmidt Bies, stated “[w]e are generally pleased with both the industry’s self-identification of the issues and its commitment to making improvements.”¹³¹

The Major Dealers continued their efforts at maintaining the momentum of their industry initiative, calling for greater participation by the industry in a July 2006 letter to their fellow credit derivatives market participants.¹³² The Major Dealers called for increased

127. The Major Dealers were working with the “ISDA, the members of CDS IndexCo LLC and International Index Company, and various service providers to develop a new framework for the settlement of credit derivatives contracts following a credit event. The settlement solution will provide for net physical settlement at a single auction-based price.” Third Industry Letter, *supra* note 123.

128. “Each Major Dealer commits to a 70% reduction in its number of confirmations outstanding for more than 30 days on June 30, 2006 from those outstanding more than 30 days on September 30, 2005.” *Id.*

129. *Id.*

130. Press Release, Fed. Reserve Bank of N.Y., New York Fed Welcomes New Industry Commitments on Credit Derivatives (Mar. 13, 2006), available at <http://newyorkfed.org/newsevents/news/markets/2006/an060313.html> [hereinafter NY Fed Press Release].

131. Susan Schmidt Bies, Governor, Fed. Reserve Bd., Address at the Financial Women’s Association Washington Briefing: A Supervisor’s Perspective on Enterprise Risk Management (June 12, 2006) (speaking on enterprise risk management issues facing the markets).

132. Letter from Senior Mgmt. of the Fourteen Indus. Participants, to Fellow Credit Derivatives Mkt. Participants & Clients (July 19, 2006), available at <http://isda.org> [hereinafter Letter to Market Participants]; see also *Credit Derivatives Dealers Cut Backlog of Confirmations by 80 Percent*, 38 Sec. Reg. &

support to realize industry-wide targets, such as: comprehensive timelines for all trade confirmations; continued progress towards electronically confirming a higher percentage of trades for all credit derivative products; adoption of new DTCC functionality; backloading existing transactions onto the DTCC (or equivalent); continued diligence in prompt execution of novations; standardized and harmonized documentation and procedures for all transactions; and, for all market participants to ensure that they had the resources in place to conform to all industry best practices.¹³³

A third meeting of the Major Dealers and regulators was held at the NY Fed on September 27, 2006.¹³⁴ The NY Fed reviewed the progress made by the Major Dealers over the last year:

- ended the market practice of assigning trades without obtaining prior consent of the counterparties,
- reduced the number of all confirmations outstanding by 70% and confirmations outstanding for more than 30 days by 85%,
- doubled the share of trades that are confirmed on an electronic platform to 80% of total trade volume, and
- agreed upon a protocol for the settlement of a credit event.¹³⁵

The NY Fed remarked that “it is important that the market participants sustain their progress toward a more automated post-trade processing environment where the vast majority of trades are now processed electronically and where there are strong risk mitigants for more complex trades,” as well as “robust adoption” of the new DTCC Deriv/Serv Trade Information Warehouse.¹³⁶

L. Rep. (BNA) No. 30, at 1270 (July 24, 2006) (summarizing the Letter to Market Participants).

133. Letter to Market Participants, *supra* note 132; see 38 Sec. Reg. & L. Rep. No. 30, *supra* note 132, at 1270 (discussing the progress made by the Major Dealers to date, and fully automated processing as the long-term industry goal).

134. Press Release, Fed. Reserve Bank of N.Y., Statement Regarding Progress in Credit Derivatives Markets (Sept. 27, 2006), available at <http://newyorkfed.org/newsevents/news/markets/2006/an060927.html>.

135. *Id.*

136. *Id.*; see *Credit Derivatives Market Swells to \$26 Trillion in Year*,

The regulators, apparently content with the progress made to date and the commitment to continue to improve, expressed looking forward to the industry making similar improvements in equity derivatives trading.¹³⁷

A. *Discussion of the Industry Initiative in the Credit Derivatives Market*

In little over a year, the Major Dealers were able to make remarkable improvements in the infrastructure of the credit derivatives market. Through collective effort, they were able to make an 80% reduction in the level of unconfirmed trades,¹³⁸ and implemented a clear industry-

Association Says, 38 Sec. Reg. & L. Rep. (BNA) No. 38, at 1590 (Sept. 25, 2006) (discussing the new statistics announced by the ISDA on Sept. 19 and quoting Geithner as being happy with the progress made in the credit derivatives market, but also mindful of the need to remain vigilant).

137. NY Fed Press Release, *supra* note 130; see Letter from Senior Mgmt. of the Seventeen Industry Participants, to Timothy Geithner, Pres. of Fed. Reserve Bank of N.Y. (Nov. 21, 2006), available at <http://newyorkfed.org/newsevents/news/markets/2006/an061121c.pdf> (committing to take similar initiatives in the equity derivatives markets, as had been made over the course of the last fourteen months in the credit derivatives markets, including increased automation and reduction of unconfirmed transactions). This commitment was welcomed by the NY Fed, which hoped to see similar progress made in the equity derivatives markets. Press Release, Fed. Reserve Bank of N.Y., New York Fed Welcomes Industry Commitments on Equity Derivatives (Nov. 21, 2006), available at <http://newyorkfed.org/newsevents/news/markets/2006/an061121.html>; see also *Firms Meet at N.Y. Fed to Ponder Questions on Credit, Equity Derivatives*, 38 Sec. Reg. & L. Rep. (BNA) No. 39, at 1636 (Oct. 2, 2006) (discussing the meeting on Sept. 27 at the NY Fed); *Equity Dealers' Plan Focuses On Market Efficiency, Standardization*, 38 Sec. Reg. & L. Rep. (BNA) No. 47, at 1994 (Dec. 4, 2006) (discussing the equity dealers' letter to NY Fed, and commitments). The Dealers made a second commitment to the Fed in May 2007, after meeting their target reduction of equity derivative confirmation backlogs by 25% by the end of January, improving automated processing and increasing the use of electronic trading platforms. Letter from Senior Mgmt. of the Eighteen Indus. Participants, to Timothy Geithner, Pres. of Fed. Reserve Bank of N.Y. (May 15, 2007), available at <http://newyorkfed.org/newsevents/news/markets/2007/FedLetter0507.pdf>; *Dealers' Pledge Added Infrastructure, Improvements in Second Commitment to Fed*, 39 Sec. Reg. & L. Rep. (BNA) No. 20, at 799 (May 21, 2007).

138. GAO REPORT, *supra* note 38, at 23:

To achieve these reductions in their unconfirmed trade backlogs, dealers took various steps. For example, dealers engaged in events called "lock ins" with other dealers and, to a lesser extent, end-users. Under a lock in, operations staff from either two dealers or staff from one dealer and one of their key end-user customers convened in a room

wide protocol to stop novations without consent. Both problems, if left unchecked, had the potential for widespread systemic uncertainty in the face of an unfavorable economic downturn or a default by a heavily referenced entity. This brings up another point which should be emphasized: this initiative was a prophylactic effort, and not the result of immediate necessity due to a financial shock.¹³⁹ This allowed the market to develop practices and strategies for long-term success, rather than applying a quick-fix to an immediate problem.

The success of the Major Dealers depended in large part upon the efforts of not only themselves, but industry associations, such as the ISDA,¹⁴⁰ and other entities that

and compared the trades they had conducted together until all or almost all were reconciled and confirmed. Dealers and end-users also used "tear-up services" to reduce the total number of open trades and thus eliminate the number of trades that needed to be confirmed. In a tear-up process, an automated system matches up offsetting positions across many market participants, allowing those trades to be, in effect, terminated and thereby removing the need to confirm such trades. . . . To prevent new trades from adding to the backlog, the dealers also increased their use of automated confirmation systems and set deadlines for confirming trades.

139. There have been some minor events that have shaken the credit derivatives markets, but these have been dealt with, notably (1) the bankruptcy filings of Northwest, Delta, Dephi, and others; and (2) in May 2005, the unanticipated correlative effects of General Motors rating falling to junk status and the sharp fall in their bond prices had effects on credit derivative portfolios and indices which contradicted the models upon which traders had relied. See Riva D. Atlas, *A Relief: Some Gains for Hedges*, N.Y. TIMES, June 8, 2005, at C1; Jonathan Fuerbringer & Danny Hakim, *Fitch Cuts G.M. to Junk, Citing Poor S.U.V. Sales*, N.Y. TIMES, May 25, 2005, at C3; Mark Whitehouse et. al, *The Sky Darkens for Bondholders—Backfiring Bets on Derivatives, Corporate Executives' Allegiances Are Among Worries Raising Risk*, WALL ST. J., May 12, 2005, at C1. Only seven reference entities have defaulted since 2005, and the market was able to effectively settle trades referencing those entities. GAO REPORT, *supra* note 38, at 15-16.

140. ISDA, About ISDA, <http://isda.org> (follow "About ISDA" hyperlink) (last visited Oct. 18, 2007):

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 815 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has

serve the technical needs of the market, such as DTCC. The ISDA's role was integral: developing standardized documentation for transactions and creating protocols in the areas of novations, collateral arrangements, settlement, and netting. The Major Dealers also relied heavily on continued dialogue with the Managed Fund Association (MFA)¹⁴¹ and Asset Managers Division of the Bond Market Association.¹⁴² These two associations were instrumental in

pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

141. MFA, headquartered in Washington, D.C., is the primary trade association representing professionals who specialize in alternative investment strategies including hedge funds, funds of funds, and managed futures funds. MFA's over 1,200 members are affiliated with the majority of the 100 largest hedge funds, which manage a significant portion of the over \$1.2 trillion invested in hedge funds. Since its inception in 1991, MFA has provided industry leadership in government relations, communications, media relations, and education to MFA members and investors. Press Release, Managed Funds Ass'n, MFA Applauds Recommendations by Senator Schumer and Mayor Bloomberg (Jan. 29, 2007), available at http://www.mfainfo.org/images/PDF/Schumer_Bloomberg.pdf.

142. The Bond Market Association merged with the Securities Industry Association to form the Securities Industry and Financial Markets Association (SIFMA) as of November 1, 2006. See, e.g., *Out of the Alphabet Soup: SIFMA*, WASH. WIRE, Nov. 1, 2006, <http://blogs.wsj.com/washwire/2006/11/01/out-of-the-alphabet-soup-sifma/>; see also Press Release, SIFMA, SIA/BMA Merger Approved by Members, SIFMA Transition Begins: Joint Statement (July 27, 2006), available at <http://www.bondmarkets.com/story.asp?id=2536> (discussing the shareholder approval of the merger).

[SIFMA is an] organization [that] is passionately dedicated to representing more than 650 member firms of all sizes, in all financial markets in the U.S. and around the world. We are committed to enhancing the public's trust and confidence in the markets, delivering an efficient, enhanced member network of access and forward-looking services, as well as premiere educational resources for the professionals in our industry and the investors whom they serve.

SIFMA, Welcome to SIFMA.org, <http://www.sifma.org/section.cfm/about> (last visited Feb. 4, 2007).

the progress made by the Major Dealers.¹⁴³

The achievements of the Major Dealers in reducing backlogs and implementing consent-required novation practices are all *derived* from the success of the market in developing and applying a greater degree of standardization and automation.

The ISDA paved the way for harmonization and automation through standardization in documentation in OTC derivatives. One of the first of such efforts was the 1992 Master Agreements, followed by the revised Master Agreement in 2002.¹⁴⁴ The ISDA has also developed protocols for Credit Support/Margin¹⁴⁵ and Novation,¹⁴⁶ as

143. See Third Industry Letter, *supra* note 123 (acknowledging the contributions made by these associations); see also MANAGED FUNDS ASS'N, STATEMENT OF SUPPORT IN RESPONSE TO THE MAJOR DEALERS' STEADY STATE PROPOSAL (Mar. 13, 2006), available at http://www.managedfunds.org/downloads/3-13-06MFA_Fed14_Stmt_3_13_06.pdf (discussing the Major Dealers initiative and the MFA's continuing support in that undertaking).

144. When two parties negotiate and sign an ISDA Master Agreement, they agree upon the ongoing legal and credit relationship between them. While they can, of course, agree to amend the terms of their agreement at any time, there is no need to negotiate a whole host of issues each time they enter into a new transaction. Also, unlike many other financial master agreements, the ISDA Master Agreement can be used to document a range of different types of transactions (it is "multi-product"). ALLEN & OVERY, LLP, AN INTRODUCTION TO THE DOCUMENTATION OF OTC DERIVATIVES "TEN THEMES" 2 (May 2002), available at <http://isda.org/educat/pdf/ten-themes.pdf> (providing a comprehensive explanation of the structure and format of the standardized documents created by the ISDA for the OTC derivatives markets). Each individual transaction between two parties to a Master Agreement becomes a supplement to the Master Agreement, and therefore incorporates all of the terms agreed to by the parties in that agreement, allowing parties to negotiate only the economic terms for each transaction, rather than entire separate comprehensive agreements. *Id.* at 2-3.

145. Credit support (a.k.a collateral or margin) are the assets that parties reserve and designate to ensure that an obligation will be fulfilled, thereby reducing counterparty credit risk. The ISDA published four Credit Support Annexes and Deeds in the mid-1990s, but

[t]he 2001 ISDA Credit Support Protocol offers market participants the ability to amend the 1994 ISDA Credit Support Annex (New York law) and/or the 1995 ISDA Credit Support Annex (English law). Specifically, market participants may elect to amend provisions relating to transfer timing, dispute resolution, substitutions or exchanges of credit support and certain definitions.

ISDA, *2001 ISDA Credit Support Protocol*, <http://isda.org> (follow "ISDA Protocols" hyperlink; then follow "2001 ISDA Credit Support Protocol" hyperlink); see also ALLEN & OVERY, *supra* note 144, at 5.

well as publishing Definitions¹⁴⁷ and gathering legal opinions on issues facing the enforcement of ISDA documentation.¹⁴⁸ Another important function of the ISDA has been the development of protocols for the settlement of obligations following credit events by the reference entity.¹⁴⁹ The ISDA was also instrumental in developing the

146. See *supra* note 105, for a discussion of the 2005 ISDA Novation Protocol. Also, the ISDA issued the Novation Protocol II in February 2006. "NPII is a free-standing protocol intended for parties that did not adhere to the 2005 Novations Protocol and those that wish to do novations business with these parties. The 2005 Novations Protocol continues to operate without amendment." News Release, ISDA, ISDA Opens 'Evergreen' Novation Protocol: Enables New Entities to Expedite Assignment Process (Feb. 1, 2006), available at <http://isda.org> (follow "Press" hyperlink; then follow "Press Releases (2006)" hyperlink; then follow "Press Release" hyperlink for February 1, 2006); see also ISDA, DETAILS RELATING TO THE ISDA NOVATION PROTOCOL II, available at <http://isda.org> (follow "ISDA Novation Protocol" hyperlink; then follow "here" hyperlink for a brief explanation of the differences between the ISDA Novation Protocol and the 2005 Novation Protocol) (stating that there are no changes to the novation terms from the 2005 Novation Protocol to the Novation Protocol II).

147. ALLEN & OVERY, *supra* note 144, at 3:

When used in the ISDA sense, "Definitions" are the various booklets of standard definitions and other terms and provisions published by ISDA for use in documenting different types of derivatives transactions. Generally, and broadly, each set of Definitions provides relevant terms for documenting a particular type of derivatives transaction. . . . [S]hort-form Confirmations rely on Definitions. They do this by stating that they incorporate a particular set (or sets) of Definitions. However, while they do a lot of the work for the parties, ISDA Definitions do not take care of everything. The Definitions themselves only provide a framework for documenting a transaction. It is still up to the parties to make various choices and to document the economic terms of the transaction itself in the short-form Confirmation. The parties are also free, of course, to amend the terms of the relevant Definitions or include additional provisions in the short-form Confirmation itself. While the terms of the Definitions represent the result of an extensive industry consultation process, they will not be appropriate for documenting all transactions without amendment or additional provisions.

148. The ISDA gathered legal opinions in many jurisdictions relating to collateral arrangements, netting, and novation. These opinions are available to members to ensure that the ISDA documentation in these areas are enforceable. See ALLEN & OVERY, *supra* note 144, at 5.

149. The ISDA created *ad hoc* protocols to deal with settlement of obligations that became due when a reference entity experienced a credit event. These protocols typically involve an auction methodology that facilitates settlement through bidding on acceptable terms of physical and cash settlement. See ISDA, <http://isda.org> (follow "ISDA Protocols" hyperlink) (last

information sharing “language” that allows for automated trade processing, called FpML.¹⁵⁰

Also integral in developing a greater degree of automation were services such as the DTCC Deriv/Serv,¹⁵¹ which made substantial progress in increasing the functionality of electronic trade processing. DTCC Deriv/Serv Trade Information Warehouse¹⁵² is a massive undertaking that will revolutionize the OTC derivative market. It is a centralized repository for all transactions that will promote efficiency in all aspects of trading: confirmations, processing, novations, and settlement. The efforts of the DTCC should be looked at in conjunction with the collective effort of the Major Dealers—such developments would most likely have not been so aggressively pursued if it were not for the joint commitment to automation by the collective market.

The regulatory agencies also played a vital role in the improvements in the credit derivatives market, both through what they *did* do, and what they *did not* do. While the success of the industry initiative should be attributed to

visited Oct. 18, 2007), for a list of protocols that have been developed to deal with the settlements due to the credit events of Dura Operating Corporation (filed for bankruptcy on October 30, 2006), Dana Corporation (filed for bankruptcy on March 3, 2006), Calpine Corporation (filed for bankruptcy on December 20, 2005), Delphi Corporation (filed for bankruptcy on October 8, 2005), Delta Airlines, Inc. and Northwest Airlines, Inc. (filed for bankruptcy on September 14, 2005) and Collins & Aikman Products Co. (filed for bankruptcy on May 17, 2005).

150. FpML, What is FpML?, <http://www.fpml.org/factsheet.html> (last visited Feb. 12, 2007) (explaining the development of this standardized “language” for communicating details of financial transactions which is a necessary step in increasing automation, as well as the benefits of such standardization and automation as opposed to the manual process of derivative trading):

FpML® (Financial products Markup Language) is the business information exchange standard for electronic dealing and processing of financial derivatives instruments. It establishes a new protocol for sharing information on, and dealing in swaps, derivatives and structured products. It is based on XML (Extensible Markup Language), the standard meta-language for describing data shared between applications. All categories of over-the-counter (OTC) derivatives will eventually be incorporated into the standard.

151. See *supra* notes 111-13 and accompanying text for a description of DTCC Deriv/Serv.

152. See *supra* note 126 (discussing the Trade Information Warehouse).

the market participants, it was the instigation¹⁵³ of the regulatory agencies and threat of their intervention which initially provoked the efforts of the Major Dealers:

All of the dealers recognized the current weaknesses of their methods and were desirous of change. However, no individual dealer could have unilaterally adopted procedures without the cooperation of the broader group. Today, after the intervention of the regulators, the infrastructure that supports the credit derivatives market is substantially stronger.¹⁵⁴

As important as the instigation of the process was, this Comment argues that the stepping back of the regulatory agencies into a passive role was equally critical to the success that was achieved. This put the burden on the market participants to come up with solutions best fitted to the conditions that existed in the market, a task for which they, who collectively constitute that market, are best suited because of their day-to-day experience—much more so than regulatory agencies who are removed from the actual market and not in touch with the constant changes taking place at the market level. It was the joint regulatory initiative that brought the group of Major Dealers together and ensured that they would collectively work to correct the problems facing the market.¹⁵⁵

B. *Success of the Initiative*

The question of the success of the Major Dealer

153. Particularly, the NY Fed call for a meeting of the fourteen major market participants. See *supra* note 101 and accompanying text; see also FSA Letter, *supra* note 70.

154. Annette L. Nazareth, Comm'r, Sec. & Exch. Comm'n, Remarks Before the Brooklyn Law School Symposium on the Structure of Securities Markets (Nov. 10, 2006), available at <http://sec.gov/news/speech/2006/spch111006aln.htm>. While this author agrees with the proposition that regulatory agencies were the "impetus" for the Major Dealers collective efforts, I do not agree with the characterization of this speech that the success in the credit derivatives should be attributed to regulatory intervention. See *id.* As will be discussed *infra*, the role that the regulatory agencies played was vital, but limited, which was in itself a major factor in the success of the initiative.

155. GAO REPORT, *supra* note 38, at 27-28. "Given that individual efforts could not fully resolve the backlog problem, U.S. and foreign regulators we interviewed said that the joint regulatory initiative proved instrumental in ensuring that the problem was addressed." *Id.* at 37.

initiative in solving the problems in the credit derivatives market has many facets. As far as operational risks, the market made extraordinary advances in less than a year to clear 80% of unconfirmed trades. Through collective effort and reliance on membership organizations such as the ISDA, the market as a whole has made drastic increases in the degree of automation and standardization of trades. There is wide adherence to the ISDA Novation Protocols for consent-required assignment of trades. All of which leads to greater operational efficiency and legal certainty. In April of 2006, one U.K. regulator commented:

[T]he credit derivative exercise is well on its way to becoming an excellent example of the ability of the industry to solve a problem when it puts its mind to it as well as an excellent example of the ability of industry and regulators from around the world to work together to resolve market issues without resorting to writing new rules.¹⁵⁶

This Comment highlights the great success of implementing an industry initiative process to solve market problems, but as that regulator pointed out in his address, there is still work to be done. An 80% reduction in unconfirmed trades is an impressive improvement,¹⁵⁷ but there are still a significant percentage of trades that remain unconfirmed. While the risk posed by unconfirmed trades has been considerably lessened, it still remains a potent risk to the market, which must be eradicated (and it should be noted, the progress continues). A major area of improvement will be the continued progress in increasing automation in OTC trades.¹⁵⁸

156. Thomas Huertas, Dir., Wholesale Firms Div. & Banking Sector Leader, Fin. Servs. Auth., *Credit Derivatives: Boon to Mankind or Accident Waiting to Happen?*, Remarks Before Rhombus Research Annual Conference (Apr. 26, 2006), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0426_th.shtml.

157. The Major Dealers also cut the number of total confirmations outstanding more than 30 days by 94% by October 2006. GAO REPORT, *supra* note 38, at 4.

158. See Richard Beales, *Continuing Rapid Growth in Deals Stretches Technological Resources*, FIN. TIMES, May 28, 2007, at 18 (warning of the problems that could creep back into the credit derivatives markets as the volume of trading continues to increase, and stressing the need for even greater degree of automation). As proof of the continuing need to increase automation, many firms experienced a significant amount of backlogs during August 2007 as

Further progress in the credit derivatives market can be seen by the pledge of twelve trade associations, including the ISDA and SIFMA, to “enforce strict self-discipline and to educate their members and others on how material nonpublic information should be handled.”¹⁵⁹ These pledges come in response to concerns that the pricing of credit default swaps was moving suspiciously just before the announcements of leveraged buyouts of the reference entity.¹⁶⁰ Another issue that remains on the forefront of the credit derivatives market is how the market will develop in light of the creation of futures trading in credit derivatives,¹⁶¹ and the important role that these could take on in the financial markets.¹⁶²

Other important risks still remain prevalent in the credit derivatives market: *model risk*¹⁶³ and *risk of systemic financial shocks*.¹⁶⁴ These risks are interrelated, both

volumes surged even though more than 90% of trades were being processed electronically. See Stacy-Marie Ishmael, *Back Offices Feeling the Strain of Credit Crisis Trading Boom*, FIN. TIMES, Aug. 14, 2007, at 37.

159. Serena Ng, —*Trading Groups Are Agitating Over Apparent Leaks on Street*—, WALL ST. J., Dec. 14, 2006, at C3; *Non-Tolerance of Misuse of Insider Info Reaffirmed by Industry Groups*, 38 Sec. Reg. & L. Rep. (BNA) No. 49, at 2096 (Dec. 18, 2006).

160. Ng, *supra* note 159, at C3. These pledges also came in the face of recognition that the regulatory agencies, i.e., the SEC and CFTC, had no authority to regulate CDSs. See Kara Scannell, Serena Ng & Alistair MacDonald, *Can Anyone Police the Swaps?*, WALL ST. J., Aug. 31, 2006, at C1 (stating that the ISDA says that the SEC, which has not brought any actions in relation to the CDSs, has no jurisdiction because the swaps are private contracts, and that the CFTC itself says it has no oversight).

161. The Chicago Mercantile Exchange and the Chicago Board of Trade (two futures exchanges) have launched futures trading of credit derivatives contracts, most likely expanding the market even further. See Anuj Gangahar et al., *Banks' Unease Helped Drive the Rival Offer*, FIN. TIMES, Mar. 16, 2007, at 28; Ellen J. Silverman, *CME, CBOT Differ on Credit Derivatives*, GLOBAL ASS'N OF RISK PROFESSIONALS, Nov. 9, 2006, <http://garp.com/risknews/newsfeed.asp?Category=6&MyFile=2006-11-09-13811.html>.

162. See Michael Mackenzie & Saskia Scholtes, *Default Fear Lifts Demand for Credit Insurance*, FIN. TIMES, Aug. 7, 2007, at 35 (describing the important role of credit derivative index contracts, especially the US CDX, in the current financial landscape).

163. The risk that your pricing models are not correct, i.e., do not provide adequate compensation for the risk that you incur in a position. See DURBIN, *supra* note 1, at 191.

164. Borrowing a phrase from the CRMPG II REPORT. CRMPG II REPORT, *supra* note 87, at 1; see *Treasury Official Warns Hedge Funds: Don't Be 'Lulled'*

becoming more prevalent and harder to calculate as financial products become more complex and harder to model.¹⁶⁵ Pricing of a position depends on the return that position offers, but also the risk that the position poses. The CRMPG II Report and the Joint Forum Report both advocated better risk management practices through more comprehensive stress testing and scenario analysis.¹⁶⁶ Those reports pointed out the risk posed by unknown/uncalculated correlations, which could lead to systemic loss if one default or shock triggers others—creating a domino effect.¹⁶⁷

Unfortunately, these risks are hard to mitigate in the market through collective action. It depends on prudent risk management policies (hedging positions through

on Possible Systemic Risk, 39 Sec. Reg. & L. Rep. (BNA) No. 24, at 942 (June 18, 2007) (warning of the need to increase the sophistication of risk management systems, especially in the credit markets).

165. See *Banks Chart Significant Progress Toward Key Management Goals*, 38 Sec. Reg. & L. Rep. (BNA) No. 10, at 366 (Mar. 6, 2006) (quoting E. Gerald Corrigan, chairman of CRMPG II: “As complex as it is today, its going to get more complex—there’s no question about that”). Corrigan also said that this will require market participants to strengthen valuation practices, use more sophisticated tools to evaluate the relationship between risk and capital, liquidity and margin, and increase focus on comprehensive forms of stress testing and scenario analysis. *Id.*; Paul J. Davies, *Banks and Brokers Pay a Higher Price for Volatility*, FIN. TIMES, July 13, 2007, at 37 (describing the worries over complex products, counterparty risk, and correlations between various markets).

166. See CRMPG II REPORT, *supra* note 87, § V (discussing correlation and modeling risk); JOINT FORUM REPORT, *supra* note 79, at 35-38 (discussing potential problems with correlation); Anderson, *supra* note 39, at C1 (discussing NY Fed president Geithner’s commitment to improve stress testing); Greg Ip & Carrick Mollenkamp, *U.S. & Britain Team Up to Test Financial Risk*, WALL ST. J., Mar. 2, 2006, at C1 (discussing model risk and stress testing in the credit derivatives market); Emil Henry, Treasury Asst. Sec’y for Fin. Insts., Remarks at Federal Reserve Bank of Atlanta (Apr. 18, 2006) (discussing the nexus between hedge funds and credit derivatives and the need for more comprehensive stress testing); see also Treasury’s Henry Urges Attention to Link Between Hedge Funds, Credit Derivatives, 38 Sec. Reg. & L. Rep. (BNA) No. 17, at 706 (Apr. 24, 2006) (discussing Henry’s speech, *supra*); *supra* note 139 (discussing the unexpected correlation effects of G.M. bonds being downgraded to junk status).

167. Much of the recent worries about such systemic risk arises from the volatility in the credit derivatives market resulting from possible correlations between the subprime mortgage problems and credit derivatives; “[t]he market is convinced that somebody out there is holding a big bag of subprime.” Scott Patterson, *Default Swaps Could Magnify Credit Crisis*, WALL ST. J., Aug. 13, 2007, at C1 (quoting a credit strategist at Deutsche Bank).

diversification to minimize risk concentration) and proper attention to correlation in price modeling and overall risk management models.¹⁶⁸ This is the province of individual firm policy, and there is no objective measure of effectiveness for each entity's stress testing and scenario analysis practices.

The real measure of the success in the credit derivatives market will probably not be able to be determined until a truly devastating shock to the market. Therefore, it is up to each market participant to satisfy itself that it is making sound decisions and implementing sound policies to deal with these risks, and unfortunately, the market as a whole will have to wait until a catastrophic event impacts the market to find an objective measure of those efforts.

V. BROADER RECENT REGULATORY CONCERNS

As foreign markets develop and become more stable, they become increasingly attractive alternatives to U.S. markets.¹⁶⁹ This increase in global competition has led many to begin reevaluating U.S. regulation of financial markets.¹⁷⁰ The U.S. has a fragmented regulatory approach for dealing with the financial world. The banks are regulated by one set of groups,¹⁷¹ securities by another,¹⁷²

168. See Thomas Huertas, Dir., Wholesale Firms Div., and Banking Sector Leader, Fin. Servs. Auth., Remarks at the ISDA Regional Conference: One Down, Two to Go? Challenges Facing the Global Derivatives Industry (Sept. 19, 2006), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0919_th.shtml (discussing how the industry values derivatives, and whether that valuation is based on adequate stress testing).

169. See Greg Ip et al., *In Call to Deregulate Business, a Global Twist*, WALL ST. J., Jan. 25, 2007, at A1; Henry M. Paulson, Sec'y, U.S. Treasury Dep't, Address at the Competitiveness of U.S. Markets Economic Club of New York (Nov. 20, 2006), available at <http://www.ustreas.gov/press/releases/hp174.htm>.

170. See, e.g., Michael R. Bloomberg & Charles E. Schumer, *To Save New York, Learn from London*, WALL ST. J., Nov. 1, 2006, at A18 (calling for reevaluation of U.S. regulatory, accounting, and legal systems to maintain U.S. financial preeminence).

171. Banks are regulated by the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

172. Securities are regulated by the SEC as well as those self-regulatory organizations to which the SEC has delegated authority, and is subject to state

commodities and futures by another,¹⁷³ and insurance companies by still another assemblage of regulators.¹⁷⁴ The problems associated with this disjointed regulatory set-up have been at the forefront of many recent discussions of U.S. regulation.¹⁷⁵

This fragmentation leads to redundancy, which increases costs and reduces efficiency. Compounding the problem is the internal overlap of regulatory authority within each individual framework.¹⁷⁶ "As a consequence, the fragmented U.S. financial regulatory system has become increasingly filled with friction and even dysfunctional."¹⁷⁷

In today's financial reality, we must ask the question: does this artificial compartmentalization of industries create a regulatory framework that is best suited for the way that markets actually function? More and more complex financial products are developed which reference not only securities and bonds, loans, futures, commodities,

regulation from Blue-Sky Laws.

173. The futures and commodities industries are regulated by the Commodity Futures Trading Commission and the SROs to which it has delegated rulemaking authority.

174. The insurance industry is regulated by the states, with each state having its own set of regulations. The regulation of the insurance industry is the epitome of the redundant and inefficient form of regulation that this Comment is arguing must be changed. In the insurance industry, each state maintains its own rules and regulations making every decision made by insurance companies dependent upon maintaining compliance with, and seeking approval from, dozens of regulatory agencies; each with its own standards.

175. See, e.g., MCKINSEY REPORT, *infra* note 194, at 81 ("Exhibit 21: The U.S. Regulatory Regime is Complex and Fragmented," illustrating the numerous regulators assigned to oversee each component of the financial services markets); "We have the SEC, CFTC, NASD, MSRB, 50 state insurance regulators, multiple banking authorities—all looking at specific products within their own jurisdiction, but rarely working in concert." Mary L. Schapiro, Chairman & C.E.O. of the NASD, Remarks at the Investment Company Institute General Membership Meeting (May 11, 2007), available at <http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P019144>.

176. See Judith Burns & Randall Smith, *SEC Chairman Backs Creation of One Regulator for Brokerages*, WALL ST. J., Nov. 11, 2006, at B3.

177. CCMR REPORT, *infra* note 179, at 67; see Markham, *supra* note 18, at 319-74 (discussing U.S. specifically focusing on securities and commodities, futures markets, and modern problems facing the regulation of these markets, as well as the conflicts between the SEC and CFTC over jurisdiction).

and every combination thereof that can be conceived, but also synthetic positions that can be based on nothing more than abstract market perceptions at a given moment. To add even more complexity, there are many and varied institutions (banks, hedge funds, brokers, dealers, etc.) participating in these markets. Recognizing this reality, the question then evolves into how best to overlay the U.S. regulatory framework over the current markets.¹⁷⁸

In November 2006, the Committee on Capital Markets Regulation (CCMR) issued an Interim Report.¹⁷⁹ This report was specifically addressed to the President of the United States, in hopes that he will direct the President's Working Group on Financial Markets to "implement reforms to protect the competitiveness of the U.S. public capital markets."¹⁸⁰

The CCMR Report found that U.S. financial markets are suffering from a loss of competitiveness due to:

178. See SEC. INDUS. & FIN. MKTS. ASS'N, REINVENTING SELF-REGULATION, WHITE PAPER FOR THE SEC. INDUS. ASS'N (2000, updated Oct. 14, 2003) http://www.sia.com/market_structure/html/siawhitepaperfinal.htm (discussing securities regulation and offering six options for alternative regulatory models, ranging from maintaining the status quo to forming a single governmental regulatory organization); Jake Keaveny, Note, *In Defense of Market Self-Regulation, An Analysis of the History of Futures Regulation and the Trend Toward Demutualization*, 70 BROOK. L. REV. 1419, 1420 (2005) (arguing "that the self-regulatory model, while in need of some type of reform, will survive the latest round of scrutiny because time has shown that it is the most efficient and practical alternative").

179. COMM. ON CAPITAL MARKETS REGULATION INTERIM REPORT (Nov. 30, 2006), available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf [hereinafter CCMR REPORT].

The Committee on Capital Markets Regulation is an independent, bipartisan committee composed of 22 corporate and financial leaders from the investor community, business, finance, law, accounting, and academia. Announced on September 12, 2006, its purpose is to explore a range of issues related to maintaining and improving the competitiveness of the U.S. capital markets. Our objective is to recommend policy changes that should be made, or areas of research that should be pursued, to preserve and enhance the balance between efficient and competitive capital markets and shareholder protection. This interim report focuses on equity capital markets. During the next two years, our Committee will continue to explore issues affecting other aspects of the competitiveness of U.S. capital markets.

Id. at vii.

180. *Id.* at 1.

(i) an increase in the integrity of and trust in major foreign public markets resulting from more transparency and better disclosure; (ii) a relative increase in the liquidity of foreign and private markets, thus making it less necessary to go to the U.S. public equity capital markets for funding; (iii) improvements in technology, making it easier for U.S. investors to invest in foreign markets; and (iv) differences in the legal rules governing the U.S. public markets and the foreign and private alternatives.¹⁸¹

These factors are all explored at length in the CCMR Report; however, this Comment will limit its focus to those recommendations concerning regulatory reform.¹⁸²

The recommendations in the CCMR Report for regulatory reform focus on four areas (1) improved cost/benefit analysis of regulation; (2) a shift to more principles-based form of *rules*; (3) adopting a more prudential supervisory regime; and (4) greater domestic

181. *Id.* at 4-5. *But see* Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Is Excessive Regulation and Litigation Eroding U.S. Financial Competitiveness? (Apr. 20, 2007), available at <http://sec.gov/news/speech/2007/spch042007psa.htm> ("The United States emerged from the end of World War II with its capital, industrial and scientific structures intact. The rest of the industrialized world lay in ruins. Communism and socialist ideas then suppressed the formation of financial markets in many parts of the world. So for many decades, these external factors made the United States the dominant financial marketplace in the world. Regardless of our regulatory costs, there were no other financial marketplaces with the size, liquidity, and depth of the United States—a position that we have continued to maintain to this day. . . . With burgeoning foreign capital centers and easy direct access of Americans to those markets, foreign companies no longer *have* to come here.").

182. Other recommendations discussed in the CCMR REPORT deal with (1) reforming public and private sector enforcement by allowing companies to adopt limits to their exposure to class actions, reserving criminal prosecutions for truly exceptional cases, reducing the present level of auditor liability, recognizing the practical difficulties in the present requirements facing outside directors acting in good faith reliance on prepared information, and allowing greater indemnification of those outside directors acting in good faith; (2) improving shareholder rights, especially in the areas of their right to vote on takeover defenses and the adoption of alternative dispute resolution procedures; and (3) revising implementation of section 404 of the Sarbanes-Oxley Act through greater clarity in defining "material weakness," better regulatory guidance, and revised requirements for small companies and foreign companies. *See* CCMR REPORT, *supra* note 179, at 12-21 (citing to executive summary, and also discussing at greater length in sections III, IV, and V). It should also be noted that the regulatory reforms of the CCMR REPORT are directed specifically at securities regulation, but many of the recommendations could be applied to the much broader issue of financial services market regulation as a whole (that being the focus of this Comment).

and international cooperation among regulators.¹⁸³ A model of regulatory framework frequently discussed in the report is the United Kingdom's Financial Services Authority (FSA), which is already premised on a principles-based approach and has been hailed as an example of prudential regulation.

The CCMR recommends that the SEC and self-regulatory organizations (SROs) focus much more energy on evaluating the costs and benefits associated with proposed rules, and in reassessing the practicality of existing rules.¹⁸⁴ The CCMR offers four possible ways to implement a greater focus on cost/benefit analysis, ranging from legislative enactment of such a requirement to voluntary adoption of such analysis by the regulators.¹⁸⁵ By following a cost/benefit approach to assessing regulation, regulators would promote greater efficiency and reduce unnecessary costs to the market.

The CCMR also suggests a shift to a more principles-based form of regulation, which would involve reassessing and reformulating the existing rules into a much simpler set, or sets, of guiding principles based on the differing needs of the market:

Sensible principles of good regulation, including efficiency, economy, and proportionality, suggest that rules reflect the differing needs for protection, both in types and amount, of various investors whose knowledge, sophistication, and understanding varies. Therefore, these same principles would dictate different, at least in part, rulebooks for dealings with wholesale and retail investors. No doubt, the proper application of a cost-benefit

183. *Id.* at 59.

184. *Id.* at 60-63.

185. *Id.* First, regulators, specifically the SEC, could submit proposed rules and regulations to the Office of Management and Budget's Office of Information and Regulatory Affairs for an assessment of potential costs and benefits, and this could become another input in the rule-writing process. The Office of Management and Budget is an office in the executive branch, which performs similar assessments for all significant executive agency actions (the SEC is an "independent" agency not currently subject to such a review). Second, is the creation of a separate agency to perform such cost/benefit analysis for SEC proposals. Third, such analysis could be performed internally by creating a new division within the SEC. Fourth, the SEC could incorporate such analysis into its existing rule-writing processes.

analysis would lead to the same conclusion.¹⁸⁶

The CCMR also contends that the present “high-profile” strategy of securities regulators, which focuses on compliance with specific rules and broad publicity of enforcement actions, is at odds with the reforms contemplated in the report.¹⁸⁷ The CCMR recommends a shift to a more open dialogue between the regulators and the regulated, and a prudential approach that concentrates on the “safety and soundness” of the financial system, more in line with the approach of banking regulators.¹⁸⁸ This approach would engender more willingness of the regulated entities to bring their problems to the regulators rather than hiding those problems from fear of public disciplinary action.¹⁸⁹

A corollary to this issue is the CCMR’s proposal that regulators refrain from using enforcement action to “refashion existing rules.”¹⁹⁰ This *ad hoc* approach to rulemaking and enforcement “has the effect of engendering greater uncertainty in the marketplace” and reducing the willingness of regulated entities to communicate their regulatory concerns to the regulating agencies.¹⁹¹

The final recommended course of action by the CCMR Report is to increase cooperation and dialogue among federal regulators, as well as between federal and state regulators, to reduce the friction and “duplicate[ive] structure that leads to both inconsistent rules and a waste of resources.”¹⁹² This call for domestic coordination and the recognition of the need for greater international regulatory cooperation can best be achieved by the shift to a more harmonized principles-based form of regulation rather than trying to synchronize numerous extensive sets of prescriptive rules.¹⁹³

186. *Id.* at 65.

187. *Id.* at 66.

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.* at 67.

192. *Id.* at 68.

193. *Id.* at 68-70.

The recommendations made by the CCMR are all interrelated: cost/benefit analysis would be a fundamental precept in a shift to a more principles-based approach to regulation, which in turn would stimulate a more prudential regulatory approach leading to greater dialogue between the regulators and regulated. A move to a more principles-based regulatory approach would make it easier to harmonize both domestic and international regulation.

Another recent report, the McKinsey Report, was commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer (D., N.Y.) to evaluate the competitiveness of U.S. financial services markets.¹⁹⁴ The McKinsey Report makes recommendations for broad reform to the regulation of financial services industry in the U.S., and does not restrict its discussion to the securities markets (as did the CCMR Report).

The McKinsey Report makes eight recommendations to increase the U.S.' competitiveness in the modern global marketplace.¹⁹⁵ These recommendations consist of (1) providing clearer guidance for implementing the Sarbanes-Oxley Act; (2) implementing securities litigation reform; (3) developing a shared vision for financial services and a set of supporting regulatory principles; (4) easing restrictions facing skilled professional workers (particularly immigration policies); (5) recognizing the International Financial Reporting Standards without reconciliation with U.S. GAAP, and eventual convergence to a harmonized set

194. MCKINSEY & CO., SUSTAINING N.Y.'S AND THE U.S.' GLOBAL FIN. SERVS. LEADERSHIP (Jan. 2007), available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf [hereinafter MCKINSEY REPORT] ("Mayor Bloomberg and Senator Schumer asked McKinsey & Company to work with the New York City Economic Development Corporation (NYCEDC) to develop a better understanding of the contribution that strong, innovative financial markets can make to a vibrant economy. . . . To bring a fresh perspective to this topic, a McKinsey team personally interviewed more than 50 financial services industry CEOs and business leaders. The team also captured the views of more than 30 other leading financial services CEOs through a survey and those of more than 275 additional global financial services senior executives through a separate on-line survey."); see also Aaron Lucchetti, *Identity Crisis for New York?*, WALL ST. J., Jan. 22, 2007, at C3 (discussing the release of the MCKINSEY REPORT).

195. MCKINSEY REPORT, *supra* note 194, at 97-118. The MCKINSEY REPORT also has a thorough discussion of U.S. competitiveness in today's markets (Section II), and some specific suggestions for increasing New York's competitiveness (Section IV (B)).

of accounting standards; (6) rethinking the U.S. modifications to the Basel II Capital Accord; (7) forming a National Commission on Financial Market Competitiveness to guide the future of the U.S. financial markets; and (8) modernizing the charters of the financial services industry regulators, holding company models and operating structures.¹⁹⁶

These recommendations echo many of the reforms suggested by the CCMR Report, but also add some other proposals such as relaxing the immigration restrictions for skilled professional workers, rethinking the U.S. modifications to the Basel II Capital Accords,¹⁹⁷ and forming a National Commission on Financial Market Competitiveness. This Comment will again focus on the regulatory reforms discussed in the McKinsey Report.¹⁹⁸

The McKinsey Report states that "London already enjoys clear leadership in the fast-growing and innovative over-the-counter (OTC) derivatives market."¹⁹⁹ The McKinsey Report attributes this success in attracting derivatives activity to London's overall regulatory environment, which is perceived by business leaders to be

196. *Id.* at 95-118. These eight recommendations are divided into three categories: critically important, near term national priorities ((1)-(3)); initiatives to level the playing field ((4)-(6)); and important longer-term national issues ((7)-(8)). *Id.*

197. The efforts of the Basel Committee on Banking Supervision to revise the standards governing the capital adequacy of internationally active banks achieved a critical milestone in the publication of an agreed text in June 2004. The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. In addition, the Basel II Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop or improve their ability to manage those risks. As a result, it is intended to be more flexible and better able to evolve with advances in markets and risk management practices. BANK FOR INT'L SETTLEMENTS, *BASEL II*, <http://www.bis.org/publ/bcbsca.htm> (last visited Feb. 11, 2007).

198. Specifically "*Section II (C) Competition intensifying in two key markets: derivatives and debt* and *Section III (D) Recent US regulatory trends damaging competitiveness*" and the corresponding recommendations of the MCKINSEY REPORT, *supra* note 194.

199. *Id.* at 54.

superior to that in the U.S., and because the business community feels that U.K. regulators are more responsive and efficient.²⁰⁰ The increasing pace of innovation and new product development has put an increasing emphasis on regulatory responsiveness and flexibility:

An increasingly heavy regulatory burden and a complex, cumbersome regulatory structure with overlaps at the state and national levels is causing an increasing number of businesses to conduct more and more transactions outside the country. For many executives, London has a better regulatory model: it is easier to conduct business there, there is a more open dialogue with practitioners, and the market benefits from high-level, principles-based standards set by a single regulator for *all* financial markets.²⁰¹

The McKinsey Report highlighted three themes to help explain the growing differences between U.S. and U.K. regulatory environments: “the regulatory structure, the regulatory and supervisory approach and the regulatory enforcement.”²⁰² The report discusses the fragmented, and what has been characterized elsewhere as “dysfunctional,”²⁰³ structure of U.S. regulation of financial markets, finding that it is perceived by many as unresponsive, and consequently stifling of innovation.²⁰⁴

The McKinsey Report also criticized the U.S. regulatory approach, in contrast to the FSA principles-based approach, as relying too much on rules and compliance, which ignores the materiality of risk in favor of imposing legislatively mandated regulations, many of which date back decades and have failed to keep pace with the times;²⁰⁵ another feature that could be avoided by a shift to a principles-based system of regulation.

The McKinsey Report found that while the FSA was perceived as open to discussing potential problems without fear of reprisal, “[t]he multiple US regulators and enforcers,

200. *Id.* at 78.

201. *Id.* at 80.

202. *Id.* at 81.

203. CCMR REPORT, *supra* note 179, at 67.

204. See MCKINSEY REPORT, *supra* note 194, at 81-82.

205. *Id.* at 83-84.

by contrast, play a different game entirely.”²⁰⁶ However, the McKinsey Report does specifically mention and commend the recent credit derivatives industry initiative as a positive example of collaborative action to address and resolve issues jointly.²⁰⁷

Another intriguing recommendation of the McKinsey Report was for a new commission to assess the long-term, structural issues affecting the health, competitiveness, and leadership of U.S. financial markets, the National Commission on Financial Market Competitiveness.²⁰⁸ This Commission should evaluate the possibility of a single regulator for all financial markets, which governed by a principles-based regulatory framework, would have superior flexibility and ability to deal with emerging issues in the markets.²⁰⁹

While the McKinsey Report stopped short of calling for a wholesale replacement of the current rules-based regulatory system with a principles-based approach, it did recognize the need to develop a “clearly articulated vision, strategy and mandate” to bring greater flexibility and predictability to U.S. regulation.²¹⁰ The shift in regulatory approach should emphasize collaboration, dialogue between regulators and market participants, and emphasis on empirical effectiveness, all of which could be furthered through implementing a common set of principles for the regulation of all financial institutions in the U.S.²¹¹ The Report also stated:

In a rapidly changing and increasingly global financial marketplace, the private sector can provide information and insights on market trends, customer needs, and market impact that are valuable contributions to the decision-making process at both the local and national levels. The [National Commission on Financial Market Competitiveness] should therefore encourage ways to enhance thoughtful private sector input to any policy or regulatory decision as a means of helping to ensure better

206. *Id.* at 84.

207. *Id.*

208. *Id.* at 113-15.

209. *Id.* at 114.

210. *Id.* at 84.

211. *Id.* at 22.

implementation and execution over time.²¹²

In March 2007, a third report was issued by a bipartisan commission established by the U.S. Chamber of Commerce—the “Commission on the Regulation of U.S. Capital Markets in the 21st Century.”²¹³ This report recognized that, “at least the perception, if not the reality, of burdensome and duplicative regulatory schemes and an inefficient and unfair legal system were making the U.S. capital markets increasingly less attractive to foreign and domestic companies alike.”²¹⁴ It was against this backdrop that the Commission undertook a reconsideration of the “systems and institutions built over the past 70 years to protect investors and foster capital formation.”²¹⁵ The Commission concluded with its most fundamental recommendation, “that policy-makers and thought-leaders address these problems now, before a crisis arises,”²¹⁶ because “[w]ith the rapid expansion of global capital pools and the dramatic rise in new financial products over the last decade, it has become increasingly clear that the United States lacks an overall vision for how its legal and regulatory framework should respond to these new market developments”.²¹⁷

The Findings of the Commission are unambiguous—the competitive position of the U.S. capital markets is declining in the

212. *Id.* at 115. For a similar view on the benefits of private sector influence in regulation, see William H. Donaldson & Harvey L. Pitt, *Outdated and Inefficient*, WALL ST. J., Jan. 6-7, 2007, at A7 (“With the SROs and the industry taking the lead, the need for a governmental solution is eliminated, and that’s always a preferable course.”).

213. COMM. ON THE REG. OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, RPT. AND RECOMMENDATIONS (Mar. 2007), available at <http://www.capitalmarketscommission.com/portal/capmarkets/default.htm> (follow “Download the full report” hyperlink) [hereinafter COMMERCE REPORT]; see also Kara Scannell, *Panel Urges Steps to Boost Allure of U.S. Markets*, WALL ST. J., Mar. 12, 2007, at A1 (discussing the Commerce Report and the panels hosted by Treasury Secretary Paulson to discuss and debate U.S. competitiveness); *Panel Commissioned by U.S. Chamber Urges Ways to Advance U.S. Capital Markets*, 39 Sec. Reg. & L. Rep. (BNA) No. 11, at 413 (Mar. 19, 2007) (discussing the COMMERCE REPORT and the conferences held by the Treasury department).

214. COMMERCE REPORT, *supra* note 213, at 1.

215. *Id.*

216. *Id.* at 12.

217. *Id.* at 11.

context of heightened competition from international financial centers and a U.S. legal and regulatory system whose basic framework was established more than 70 years ago.²¹⁸

“The Commission started with the premise that its recommendations needed to strike the right balance between two statutory mandates: protecting investors and promoting capital formation.”²¹⁹ The challenges facing the U.S. regulatory framework is striking the right balance between these two goals, and ensuring flexibility in regulation to adjust to inevitable fluctuations in the many variables that affect the capital markets.²²⁰ The Commerce Report issued six formal recommendations that they believed can and should be implemented by Congress, the regulatory agencies, and the market participants within 2007.²²¹

The Commission’s recommendations were (1) reform and modernize the federal government’s regulatory approach to financial markets and market participants; (2) give the SEC the flexibility to address issues relating to the implementation of SOX by making SOX part of the Securities Exchange Act of 1934; (3) convince public companies to stop issuing earnings guidance or, alternatively, move away from quarterly guidance with one earnings per share (EPS) number to annual guidance with a range of EPS numbers; (4) call on domestic and international policy-makers to seriously consider proposals

218. *Id.* at 146.

219. *Id.* at 11.

Whenever . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

National Securities Markets Improvement Act of 1996 (NSMIA) Pub. L. No. 104-290, 110 Stat. 3416, 3424-25 (codified as amended in scattered sections of 15 U.S.C.). This language has been added to each of the three principal securities statutes—the Securities Act of 1933, Securities Exchange Act of 1934, and the Investment Company Act of 1940—demonstrating that the broader objectives of efficiency, competition, and promotion of capital formation have equal standing with the protection of investors. COMMERCE REPORT, *supra* note 213, at 120.

220. COMMERCE REPORT, *supra* note 213, at 17.

221. *Id.* at 6.

by others to address the significant risks faced by the public audit profession from catastrophic litigation, as well as the Commission's suggestion that national audit firms be allowed to raise capital from private shareholders other than audit partners; (5) increase retirement savings plans by connecting all employers of twenty-one or more employees without any retirement plan to a financial institution that will offer a retirement arrangement to those employees; and (6) encourage employers to sponsor retirement plans and enhance the portability of retirement accounts through the introduction of a simpler, consolidated 401(k)-type program.²²²

This Comment will focus on the first two of these recommendations, dealing with regulatory reform. The Commission recognized that "legal and regulatory requirements in the United States relative to Europe and Asia play an influential role in corporate decisions about where to access capital markets."²²³ The recommendations advocated by the Commission with regard to regulatory reform all reflect a change toward a more prudential and flexible form of regulation that is more closely attuned to the realities of converging markets rather than rooted in a historic adherence to the distinct spheres of regulatory authority that have developed in the U.S. "This fragmentation of our regulatory system leaves the U.S. markets open to the risk that gaps could develop where appropriate regulation is needed or that overlaps in regulation could lead to market inefficiencies."²²⁴

The Commerce Report focused on the SEC for the

222. *Id.* at 6-10. The Commission recognized the important work and findings by other groups, i.e., the CCMR REPORT and the MCKINSEY REPORT, concerned with the challenges facing U.S. capital markets and specifically limited its recommendations to reduce duplication in examination in some areas. *Id.* at 12. However, it echoed the efforts to "reform America's litigation system to reduce frivolous lawsuits." *Id.*

223. *Id.* at 21. However, the Commission also recognized that the lessened competitiveness of U.S. capital markets was a combination of the fact that European and Asian markets were developing as sound and secure markets, which increasingly will attract more companies, and should be viewed as a positive development; along with the regulatory requirements that have increased the cost of raising capital in the U.S., a lack of convergence in accounting systems between the U.S. and foreign markets, and the level of U.S. civil litigation. *Id.* at 16-17.

224. *Id.* at 117.

majority of its recommendations of regulatory reform. The Commerce Report emphasized "properly tak[ing] into account the costs and benefits of regulation and to be ever cognizant of, and address, any unnecessary and duplicative regulation."²²⁵ The Commission emphasized the need for more open communication between the SEC and the institutions that it regulates,²²⁶ as well as taking a more "prudential supervisory approach to regulation," as is used by the FSA in the U. K. and U.S. banking regulators.²²⁷ The Commerce Report even cites the Major Dealers initiative in the credit derivatives market as a prime example of such a prudential approach.²²⁸ In furtherance of this goal, the Commission suggests that the SEC take three steps (1) create an ongoing dialogue with the market participants to consult and influence the development of appropriate regulatory standards; (2) implement an "examination privilege" to further open communication by market participants; and (3) consider using resident examiners at some of the largest SEC regulated institutions.²²⁹

The Commerce Report highlights the flaw of having separate regulators for securities and futures markets:

Unlike the United States, most of the rest of the world already views all types of financial instruments as deserving a common regulatory scheme. This approach not only appears preferable for market users but it is also a much more efficient use of government resources. . . . The Commission recognizes the wisdom of having a single regulatory and supervisory framework for the securities markets and the commodities markets.²³⁰

The Commerce Report stops short of calling for a merger of the SEC and CFTC and simply recommends a regulatory realignment of the CFTC and SEC jurisdictions because of the practical impediments to such a merger.²³¹

225. *Id.* at 121.

226. *Id.* at 128.

227. *Id.* at 129-30.

228. *Id.* at 131.

229. *Id.* at 131-33.

230. *Id.* at 139.

231. *Id.* at 139-40.

The Commission also is mindful of the historical underpinnings of the

The Commission would have Congress transfer authority to the SEC for securities and securities indexes.²³² Other regulatory reforms contained in the Commerce Report are: increasing the flexibility and efficiency of regulation by realigning the structure of the SEC to more closely mirror the markets;²³³ adopting a policy of “substituted regulation”;²³⁴ issuing more informal guidance to regulated institutions;²³⁵ allowing the SEC more flexibility in implementation, and giving the market more certainty in interpretation, by making the Sarbanes-Oxley Act of 2002 part of the Securities Exchange Act of 1934;²³⁶ and increased cooperation and dialogue among all levels of regulation (state and federal), coordinated through wider participation in the President’s Working Group on

bifurcated system in this country. And the Commission is cognizant of the criticisms against simply merging the functions of the SEC and the CFTC into a single agency. For example, agricultural groups, including farmers and ranchers, which often use the commodities markets to hedge their risk, fear that their interests will become secondary to the interests of securities firms in a combined agency dominated by securities issues.

Id. at 139.

232. *Id.* at 139-40 (“Commission recommends that Congress enact legislation that transfers from the CFTC to the SEC sole regulatory and supervisory authority over trading of futures on securities, including single securities and securities indexes.”).

Currently, these products are subject to a mix of SEC and CFTC regulation. Consolidating regulatory responsibility for these products will result in more streamlined regulatory oversight and will reduce the cost of complying with multiple schemes. Under this recommendation, the CFTC would retain jurisdiction over commodity futures. The Commission cautions that the interests of the commodities market participants must be preserved in order for this recommendation to be successfully implemented.

Id. at 140.

233. COMMERCE REPORT, *supra* note 213, at 137-38.

234. *Id.* at 36-40. “Substituted compliance” would allow for foreign institutions to be exempt from U.S. regulation if there was comparable home-country regulation and bilateral information sharing between the U.S. and foreign regulator, as well as reciprocal treatment for U.S. institutions in the foreign country. *Id.* at 38.

235. *Id.* at 7. The Commission praises the SEC initiatives already in place that attempt to give such guidance through no-action letters, frequently-asked-questions (FAQs), and conferences. *Id.* at 131.

236. *Id.* at 7, 122-23.

Financial Markets.²³⁷

Contemporaneous with the release of the Commerce Report, U.S. Treasury Secretary Henry Paulson and SEC Chairman Christopher Cox co-chaired the Capital Markets Competitiveness Conference.²³⁸ This conference brought together “[s]ome of the biggest names in government and finance” to discuss the perception that U.S. competitiveness was waning.²³⁹ While there was no consensus among the panelists about the degree or reasons for this waning, Mr. Paulson stated that “disagreement among the panelists was ‘healthy because this is a complex issue as to what were the most appropriate solutions.’”²⁴⁰

As a follow-up to this conference, Mr. Paulson announced initiatives to enhance U.S. capital markets competitiveness. These initiatives included “[p]ursuing a modernized regulatory structure,” whereby the Treasury Department undertook an examination of the structure of the regulatory system and promised to release a “blueprint for reforms” in early 2008.²⁴¹

237. *Id.* at 117-19.

238. Henry M. Paulson, Jr., Sec’y, U.S. Dep’t of the Treasury, Opening Remarks at Treasury’s Capital Markets Competitiveness Conference (Mar. 13, 2007), available at <http://www.treas.gov/press/releases/hp306.htm>. Mr. Paulson stated:

Throughout the day, the fundamental question we must ask is: Have we struck the right balance between investor protection and market competitiveness—a balance that assures investors the system is sound and trustworthy, and also gives companies the flexibility to compete, innovate, and respond to changes in the global economy?

Id.

239. Deborah Solomon, *A Summit on U.S. Rules: ‘Too Gosh-Darn Complex,’* WALL ST. J., Mar. 14, 2007, at C4 (discussing the Capital Markets Competitiveness Conference).

240. *Id.*

241. Press Release, U.S. Dep’t of the Treasury, Paulson Announces Next Steps to Bolster U.S. Markets’ Global Competitiveness (June 27, 2007), available at <http://www.ustreas.gov/press/releases/hp476.htm> (other initiatives announced include Encouraging Development and Adoption of Industry Best Practices for Asset Managers and Investors in Hedge Funds; Modernize Treasury’s Cash Management and Debt Management; Complete Basel II Rulemaking; Empower All Investors through Financial Education; and Encourage International Investment Opportunities with Recognition of Comparable Regulatory Regimes). Paulson had released an earlier set of initiatives all “focused on strengthened financial reporting and a more sustainable and transparent auditing profession.” Press Release, Henry M.

Taken together, the CCMR Report, the McKinsey Report, the Commerce Report, and Treasury Secretary Paulson's efforts to address U.S. competitiveness, all illustrate important themes in the recent evaluation of U.S. regulation. Many are in favor of a shift toward a principles-based approach. There is a wide consensus that regulators should place greater emphasis and focus on cost/benefit analysis to determine the practical efficiency of proposed regulation.²⁴² There is recognition that markets are changing, consolidating, and integrating across industries that are currently compartmentalized by the U.S. regulatory framework. The alternative model of U.S. financial services regulation proposed in the next section of this Comment will incorporate all of these ideals, around the central tenet of transferring market control to the collective control of the participants, as was done in the Major Dealers initiative in the credit derivatives market.²⁴³

VI. A MODEL FOR FUTURE REGULATION?

There is widespread recognition that the U.S. needs to take a long hard look at its current regulatory system and decide how to make changes that will increase U.S. competitiveness by reducing cost and redundancy, and increasing flexibility and efficiency. Mr. Geithner recently stated: "we need to take a careful look at how we regulate

Paulson, Jr., Sec'y, U.S. Dep't of the Treasury, Paulson Announces First Stage of Capital Markets Action Plan (May 17, 2007), *available at* <http://www.ustreas.gov/press/releases/hp408.htm>.

242. See CCMR REPORT, *supra* note 179, at 59-65; COMMERCE REPORT, *supra* note 213, at 121; Robert K. Steel, Under Sec'y for Domestic Fin., U.S. Dep't of the Treasury, Strengthening Our Capital Markets Competitiveness, Remarks Before the Council on Competitiveness (May 17, 2007), *available at* <http://www.treas.gov/press/releases/hp409.htm> (discussing the Treasury Department initiatives, with special emphasis on the regulatory reforms, including "Benefit-Burden Analysis").

243. While the OTC derivatives market is not itself subject to regulation, the Major Dealers initiative is a poignant example of how market regulation could be achieved as an efficient and flexible collaborative undertaking by the actual market participants. There may be some resistance to efforts to make these "unregulated markets" subject to the same sort of oversight and cooperative action, but if this were part of an extensive revamp of the regulatory approach to all markets, this author believes that it would be successful; because, by giving up some modicum of freedom in OTC markets, there would be a much greater overall benefit of increased participation in and flexibility of rulemaking across *all* financial markets.

financial activity in a world where capital is more mobile, and the structure of the financial system has diverged substantially from the system for which our regulatory framework was designed.”²⁴⁴

Under Secretary for Domestic Finance, Robert Steel, has stated:

The current U.S. regulatory structure has been evolved over 150 years—with act on top of act, initiative on top of initiative—so that today we have a series of individual regulations, each designed in response to specific circumstances and lacking an overarching set of guiding principles. . . . If we were starting fresh and had a blank page, no one would choose to draw a regulatory structure that resembles our current picture. . . . We need a new, modernized approach to regulation—one that is risk-based, globally oriented and flexible in scope.²⁴⁵

The progress made by the Major Dealers in the credit derivatives markets is an example of how market participants can come together and make a collective effort to improve the very market upon which they all depend. Their economic livelihood is inextricably intertwined with the efficient operation of the markets in which they trade. The actual market participants are the entities best situated to come up with the most practical and efficient solutions for the problems in the marketplace because they are the ones who deal with those problems on a day-to-day basis and they are the ones who will profit the most from an increasingly efficient market. They will be motivated to move quickly and have the first-hand knowledge necessary to formulate and adapt regulation and market practices, to ensure that regulation does not become a suffocating or stifling force, but breeds innovation and encourages ingenuity.

There has been widespread approval of the Major Dealers initiative. One regulator stated that it could serve as “sort of a model for regulators for collective action to

244. Timothy Geithner, Pres. & C.E.O. of Fed. Reserve Bank of N.Y., *Economic Dynamics of Global Integration, Remarks at the Forum on Global Leadership: U.S. Competitiveness in a Globally Integrated Economy* (July 25, 2007), available at <http://www.newyorkfed.org/newsevents/speeches/2007/gei070725.html>.

245. Steel, *supra* note 242.

address other problems that might arise.”²⁴⁶ The Major Dealers initiative was also cited approvingly in the CCMR Report, the McKinsey Report, and in the Commerce Report. Assistant Secretary of the Treasury Emil Henry, Jr., remarked that the developments in the credit derivatives market were “proof of self-correcting free market capitalism at its best.”²⁴⁷ Gerald Corrigan (organizer of the CRMPG initiative) stated that he was encouraged by the progress made by the Major Dealers and that “[t]he model of private and public sector cooperation and collective action is functioning very well and is likely to have broader applications.”²⁴⁸

However, former NY Fed President, Timothy Geithner (who originally called for and hosted the meetings of the Major Dealers), said “he believes that the credit derivatives example is a special case—where the participants had an overwhelming interest in making progress—rather than a potential model.”²⁴⁹ This statement seems contrary to the recent action by the NY Fed in meeting with senior managers and compliance officers from twenty-two primary dealers to discuss ways to strengthen the integrity of the U.S. Treasury market by strengthening market practices, “so as to maintain its status as the deepest and most liquid sovereign debt market in the world.”²⁵⁰ As well as the NY

246. *Corrigan Says Probability of Systemic Train Wreck Lower*, 38 Sec. Reg. & L. Rep. (BNA) No. 47, at 2005 (Dec. 4, 2006) (quoting SEC Comm’r Annette Nazareth); see also David Wessel, *How Would Hedge Funds Behave in a Crisis?*, WALL ST. J., July 20, 2006, at A2 (discussing the success of the Major Dealers initiative in “cleaning up the back-office derivatives mess” as a model of how government can play a role in regulation, “even without new rules”); Nazareth, *supra* note 154 (approving of the Major Dealers initiative in speech).

247. Emil E. Henry, Jr., Asst. Sec’y of the Treasury, *Hedge Funds and Derivatives Markets: History, Issues and Current Initiatives*, Remarks Before the Fixed Income Forum (Mar. 9, 2006), available at <http://www.tres.gov/press/releases/js4111.htm> (speaking about the multi-faceted progress made in the credit derivatives market over the last year).

248. *Banks Chart Significant Progress Toward Key Risk Management Goals*, 38 Sec. Reg. & L. Rep. (BNA) No. 10, at 366 (Mar. 6, 2006) (quoting Corrigan, and discussing the progress made in the credit derivatives markets, as well as continuing challenges).

249. *Corrigan Says Probability of Systemic Train Wreck Lower*, *supra* note 246 (quoting Geithner).

250. Press Release, Fed. Reserve Bank of N.Y., *Statement Regarding New York Fed Meeting with Primary Dealers* (Nov. 6, 2006), available at <http://www.ny.frb.org/newsevents/news/markets/2006/an061105.html>; see also

Fed's instigation of an initiative in the equity derivatives markets that is almost identical to the Major Dealers initiative in the credit derivatives market.²⁵¹

Also, contrary to Mr. Geithner's assertion, it would seem that participants in *all* markets would have an "overwhelming interest in making progress" toward more efficient regulation.²⁵² All participants are impaired by inefficient regulation, which increases costs, wastes time and constrains innovation. Such inefficiency cuts into profits. Wouldn't participants in all markets share the underlying motivation of wanting to increase the efficiency of the regulations that dictate the extent of their freedom to pursue profit?

A. *The Model*

The theoretical regulatory model²⁵³ advocated by this

New York Fed Meets with Dealers, Treasury Seeking Ways to Improve Integrity of Market, 38 Sec. Reg. & L. Rep. (BNA) No. 45, at 1899 (Nov. 13, 2006).

251. See *supra* note 137 (discussing the initiative in the equity derivatives market).

252. See *Corrigan Says Probability of Systemic Train Wreck Lower*, *supra* note 246, and text accompanying note 249. Also, if Mr. Geithner's remarks were contemplating the fact that the Major Dealers had an increased motivation for self-correcting the problems in the industry in order to remain free of external regulation, such motivation would be inherent in *all* markets if they were given the opportunity to self-regulate as in the model proposed in this Comment. In fact, Mr. Geithner was also quoted as saying, "[w]e need to be able to move more quickly than we have in the past; we need to be prepared to work with the market and use the market to find sensible solutions—and we have to move to a more integrated framework . . ." *Corrigan Says Probability of Systemic Train Wreck Lower*, *supra* note 246. These remarks coincide perfectly with the model of regulation advocated in this Comment and lend even more support for using the Major Dealers initiative as a model for future regulation.

253. This author is not naïve enough to believe that such dramatic changes to the U.S. regulatory structure will overcome the practical hurdles to become reality; but the principles of consolidation of oversight and delegation of rulemaking to market participants are ideals that should be furthered at every given chance to increase the efficiency of regulation and thereby enhance U.S. competitiveness. However, there has been recent discussion of merging regulators with overlapping responsibilities. See Deborah Solomon, *Paulson to Launch Review of U.S. Regulatory System*, WALL ST. J., June 27, 2007, at A6 (discussing possibility of merging two banking regulators: the Office of the Comptroller of the Currency and the Office of Thrift Supervision).

At some point Congress will need to address these fundamental jurisdictional and policy issues [between the CFTC and SEC]. And dare

Comment is that of a single regulator which oversees all financial markets, but delegates to those market participants the authority to formulate the rules and practices by which each market will operate. This is an extension and adaptation of the SRO model relied upon by the securities and commodities markets in which the authority to develop specific rules to govern distinct segments of the market is allocated to the exchanges, thereby shifting some of the regulatory burden off of the governmental agency and placing it on a group that has the benefit of more direct participation in the market.²⁵⁴

This Comment suggests taking the present SRO ideal, and extending it even further. Place the responsibility for designing best practices and industry standards in the hands of those *best* suited and most plugged-in to the needs of the markets: the actual market participants, not the exchanges.²⁵⁵

The government regulator would be an oversight and enforcement body that guides all financial markets by a simple, but comprehensive set of general principles that each market would have to abide.²⁵⁶ It would also be the

I note that the issues of potential SEC-CFTC consolidation pale in comparison to the challenges, but also the potential cost savings and efficiencies, that could result from consolidation of even a few of the many federal banking regulators?

Annette L. Nazareth, Comm'r, Sec. & Exch. Comm'n, Remarks Before the Council of Institutional Investors (Mar. 20, 2007), *available at* <http://sec.gov/news/speech/2007/spch032007aln.htm>.

254. For a discussion of the development of the SRO regulatory model in the securities and commodities and futures markets, see Markham, *supra* note 18, at 325-56, and Keaveny, *supra* note 178, at 1423-38.

255. The market participants would have the most powerful motivation to ensure efficient regulation: they would all benefit from eliminating redundancy; they have the firsthand knowledge to formulate regulations that ensure competitiveness; and their daily experience in the markets will allow them to constantly assess and evaluate the current regulations, and make any necessary changes.

256. It should be noted that there is potential for abuse by a single market regulator, as recognized by Markham, *supra* note 18, at 405:

A single regulator may also seek to expand its powers after a scandal. A single regulator will also undoubtedly use bad judgment in times of crisis. A single regulator could also stifle competition, over-regulate, and cause a loss of competitive position in international markets. It could even try to . . . manage the economy by bureaucratic fiat (footnote omitted).

enforcement body of this model, ensuring compliance not only with the general principles that it will promulgate, but also with the more specific standards and rules adopted by each market. It would provide guidance and coordination by bringing to the attention of each market any problems or issues that it recognizes. But, it would then delegate the resolution of those issues to the actual market participants, who would be free to adopt the most efficient solutions (as long as those solutions are in accordance with the general principles of the government regulator).²⁵⁷

This role of the government regulator coincides with much of the recent discussions about moving toward a more prudential form of regulation (for which the Major Dealers initiative has been cited as a prime example²⁵⁸). SEC Commissioner Nazareth has described prudential regulation as:

Professor Markham's point is well taken, and correct. Without competing regulatory bodies, there is less of a check on the ability of a regulator to overreach its authority. However, many of these concerns would be offset by the use of the extended SRO model advocated in this Comment, which would dilute the control of the government regulator to a role of guidance and enforcement. Also, the government regulator would answer to Congress, and through lobbying efforts, the financial services industries would be able to exercise a modicum of control over abuse of power by the government regulator. It should further be noted that Professor Markham did not come to the conclusion that a single regulator would be not be the best approach, but rather stated that "a unified regulator seems to be a sound idea," while recognizing both the strengths and weaknesses inherent in such an approach. *Id.* at 410.

257. No regulatory structure can exist on principles alone. Markets need and want a certain degree of rules to guide and give them assurance that they are acting properly. For a discussion of the need for regulatory rules and the "overblown" dichotomy between the U.S. rules-based approach and the U.K. principles-based approach to regulation, see Roel C. Campos, Comm'r, Sec. & Exch. Comm'n, Principles v. Rules, Address Before Luxembourg Fund Industry Association & American Chamber of Commerce (June 14, 2007) (showing the need for rules in a regulatory structure, and pointing out that the FSA has an 8,000 page rulebook along with their eleven guiding principles); Robert C. Pozen, *Bernanke's False Dichotomy*, WALL ST. J., May 19-20, 2007, at A8 (describing the false dichotomy between rules-based and principles-based regulation). This Comment does not advocate market regulation based on principles alone, but merely that oversight by the government regulatory body be so based. Then, leave it to the market to develop the rules and practices based on its fundamental desire for efficient and flexible requirements.

258. Annette L. Nazareth, Comm'r, Sec. & Exch. Comm'n, Remarks Before the SIFMA Compliance and Legal Conference (Mar. 26, 2007), available at <http://sec.gov/news/speech/2007/spch032607aln.htm>.

Prudential regulation to me implies having a clear set of standards with a more flexible implementation approach for meeting those standards. It means permitting regulated entities to meet their obligations in a more customized, as opposed to “one-size-fits-all,” manner. It means more efficient regulation, not less effective regulation.²⁵⁹

Although still a far cry from a single consolidated government regulator, the U.S. regulatory agencies apparently recognize the benefits of the consolidated approach to regulation advocated by this Comment. The efforts of the different agencies who sat in on the Major Dealers’ meetings are one example, as well as the collective effort of the President’s Working Group on Financial Markets, “which consists of the Secretary of the Treasury and Chairmen of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, [and] has creatively examined system-wide issues across the legalistic and jurisdictional divides that normally separate one regulator’s thinking from another’s.”²⁶⁰

There would be two ways to coordinate the collaboration of market participants: first, through working groups, committees, and conferences arranged by the government regulator; or alternatively, through similar efforts spearheaded by membership organizations. In the first version, the government regulator would schedule periodic conferences and meetings of market participants to allow them to review existing rules and practices, and create new ones to address issues within each market. This would be directly based on the prototype of the Major Dealers initiative in the credit derivatives market. In the second version, market participants could act collectively through a membership organization, such as the ISDA in the OTC derivatives market, or FINRA, the new single-SRO for the securities industry created from the merger of the

259. *Id.* Commissioner Nazareth also recognizes that the SEC has made steps in this direction through its Consolidated Supervised Entity (CSE) Program, and that such an approach to regulation has limitations, i.e., it may not be the best approach for regulating retail sales practices.

260. *Recommendations by the President’s Working Group on Financial Markets: Hearing Before the Commission on Banking and Financial Services*, 106th Cong. 84 (Apr. 11, 2000) (statement by Hon. James A. Leach, Chairman, Comm. on Banking and Fin. Services).

NASD and NYSE regulatory branch, to address those same issues.²⁶¹ This second version is more of an extension of the SRO model now used in the securities and futures markets.²⁶² But, rather than have the SRO be a rulemaking and oversight entity for an exchange or discrete group, it could perform that same function for the entire market. The rules created by it would be the only rules for the market, not an added layer on top of an already complex system of rules and regulations promulgated by the government regulator. It could be comprised of members that were each affiliated with a market participant, but permanently assigned to be the voice of that institution in the cooperative rulemaking and oversight body for the market.

In both versions, the market participants would collaborate to solve issues in their market by establishing the practices and rules by which they would all be bound. These would be the only rules that governed the market, thereby eliminating the redundancy of multiple layers of regulation which exists today. The government regulator would oversee the practices and rules in each market to ensure conformity to the government regulator's principles, and compliance by all market participants. The more frequent the meetings of the market participants, the greater flexibility and responsiveness of regulation would

261. See News Release, NASD, NASD Member Firms Embrace Streamlined, More Efficient Regulation (Jan. 21, 2007), available at http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_018334 (discussing the merger between the two regulatory organizations into a single SRO which "create[d] a single regulator for the country's nearly 5,100 broker-dealers, eliminating overlapping regulation and reducing costs to the industry").

262. By placing the responsibility for regulating each market in the hands of the market participants through working groups organized by the governmental regulator or through non-profit membership organizations adaptation of the current SRO model, another controversy would be settled, i.e., the unrest caused by the demutualization of many exchanges. Many feel that by making exchanges a for profit enterprise, there will be increased incentive for those exchanges to become lax in their regulatory capacity and even inherent conflict between the pursuit of profit and the "separate" regulatory function of ensuring compliance by its members. For a discussion of the demutualization concerns, see Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?*, 21 NW. J. INT'L L. & BUS. 657 (2001); Keaveny, *supra* note 178, at 1438-50; see also Aaron Lucchetti, Alistair MacDonald & Kara Scannell, *NYSE, Euronext Set Plan to Form a Markets Giant—Landmark \$20 Billion Deal by U.S., Europe Exchanges Face Oversight Questions*, WALL ST. J., June 2, 2006, at A1.

be to actual market conditions.

The recent merger of the NASD-NYSE into a single self-regulatory organization, the Financial Industry Regulatory Authority (FINRA), is a significant step toward the consolidation and increased efficiency that is essential to U.S. regulatory reform.²⁶³ This merger has been praised and approved as a plan to eliminate complexity and confusion, as well as consolidating the expertise of market regulators.²⁶⁴ The benefits of the merger will be increased efficiency, reduced redundancy, and reduced cost, but this approach will still be applying externally created rules and regulation on the market.²⁶⁵ This merger also fits nicely

263. See Randall Smith, *NASD Approves Tie-up With NYSE on Oversight*, WALL ST. J., Jan. 22, 2007, at C5; News Release, FINRA, NASD and NYSE Member Regulation Combine to Form Financial Industry Regulatory Authority—FINRA (July 30, 2007), available at <http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P036329>.

264. Donaldson & Pitt, *supra* note 212, at A7 (both authors are former chairmen of the SEC) (criticizing the current state of securities regulation as “redundant and inefficient and in that context doesn’t benefit either investors or the industry,” and calling the merger “the first significant change in the self-regulatory regime in this country in more than 70 years”); see Christopher Cox, Chairman, Sec. & Exch. Comm’n, *More Efficient and Effective Regulation in the Era of Global Consolidation of Markets*, Remarks to the Securities Industry & Financial Markets Association (Nov. 10, 2006), available at <http://sec.gov/news/speech/2006/spch111006cc.htm> (“As Chairman of the Securities and Exchange Commission, I strongly support these efforts, which are currently well underway, to fold the member regulation functions of both the NASD and the NYSE into one regulatory body. I’m firmly convinced that, done properly, this can make our self regulatory system more efficient and more robust from an investor protection standpoint.”). It should be noted that not all of the comments regarding the merger have been positive. Most of the criticism focused on the perceived decrease in investor protection, subjugation of smaller market participant interests and increased industry influence as opposed to investor protection. See William F. Galvin, Sec’y of the Commonwealth of Mass. (Boston), Letter to the Editor, *Multiple Regulators Vital to U.S. Securities Markets*, WALL ST. J., Dec. 11, 2006, at A19 (“If NYSE regulation is merged into the NASD, there will be one less decision maker evaluating the conduct of market participants.”); see also Randall Smith, *NASD’s Chief Fights for United Regulators*, WALL ST. J., Dec. 15, 2006, at C1 (presenting a brief balanced review of the issues that faced the merger).

265. The market participants would have somewhat of a voice in the rules and practice promulgated by the single regulator, with ten of the twenty-three seats on the board of directors reserved for industry representation. Smith, *supra* note 264, at C1. Having a minority representation on the board of directors is a far cry from the direct industry initiative of designing the rules for the markets in which they operate, as advocated by this Comment and exemplified in the Major Dealers initiative in the credit derivatives market.

into the proposed framework for a new regulatory model proposed in this Comment as a preliminary step in moving toward a more consolidated regulatory environment, but falls short of placing the control of the market in the hands of the actual participants.

The market participants would always be motivated to approach regulation from a cost/benefit approach, thereby ensuring efficiency and hopefully fostering an environment where innovation and adaptation would be nurtured and encouraged through firsthand experience in determining the effectiveness of regulation. The ideals of investor protection and market integrity should not be discarded or ignored, but merely applied in the most effective manner to allow the U.S. markets to remain competitive.

B. *Potential Concerns*

The model of regulation proposed in this Comment does raise some potential concerns, such as the opportunity for collusion; the possibility of exclusion and subrogation of the interests of smaller participants; lessened investor protection; as well as a host of practical implementation impediments. This Comment will address and offer responses to curb some of the disquiet concerning the first three of these issues, but fully recognizes the practical concerns and impediments confronting a model of regulation calling for an extensive revamp of the entire U.S. system of regulation. Such obstacles are the purview of policymakers and lobbyists, and deal with issues well beyond the abilities of this author to overcome.²⁶⁶ However, barriers which focus not on the merits of such change, but

266. However, with the recent budgetary concerns within the CFTC, and the fact that the CFTC has not been reauthorized—the CEA expired in 2005—as well as the recent discussions of merging of certain banking regulators and of the SEC and CFTC (discussed *supra* note 253), it would seem that the time may be ripe for serious contemplation of moving toward a unified regulatory system. See *Hatfield Laments Budget, Staffing, But Sees Hope in SEC Ties as Realms Converge*, 38 Sec. Reg. & L. Rep. (BNA) No. 47, at 2011 (Dec. 4, 2006) (discussing the CFTC Comm'r Hatfield's concerns over the underfunding of the CFTC and his optimism that the "CFTC and SEC can forge a closer alliance as the worlds of equity and derivatives trading become more closely aligned," and his proposed "formal structure to link the regulators"); *CFTC Reauthorization Back, but Issue Faces Crowded Calendar for Attention*, 39 Sec. Reg. & L. Rep. (BNA) No. 3, at 99 (Jan. 22, 2007) (discussing the CFTC's concerns, primarily its underfunding and Congress's failure to reauthorize the CEA since 2005).

on the bureaucratic difficulties of implementation should not dictate the course of progress.

Some people might argue that placing the regulation of financial markets in the hands of the actual market participants would be like letting the foxes guard the henhouse. While there is always potential for abuse by some in any system of regulation, this author does not believe that the proposed model of collective control by the market would inherently engender collusion or abuse. In a collaborative regulatory environment, individual economic concerns would cause the group to deny any individual a competitive advantage. The market participants acting as a group would operate as a natural *check and balance* on any individual attempt to manipulate the system to its own advantage. Further, all regulation would be monitored by the government regulator to assure compliance with general principles, which would have an intrinsic "policing effect" on any widespread collusion. The market participants would be given the opportunity to create the most efficient and adaptable regulatory environment, but that regulation would still have to conform to the ideals of integrity, transparency, and fairness as mandated by the overseeing government regulator.

The concerns over lessened investor protection are answerable in the same vein. The government regulator would not be abandoning its role of ensuring integrity and investor protection. This Comment does not purport to lessen or change such ideals, just to allow the implementation of such principles to be decided in the most efficient manner, to ensure the competitiveness of U.S. markets.

Concern over exclusion and subjugation of smaller market participant interests could be addressed by mandatory representation of smaller interests in any policy making committee. A "one firm, one vote" policy would ensure that all market participants would have an equal voice in determining market practices and standards.²⁶⁷

267. See Smith, *supra* note 264, at C1 (describing a similar approach used by the NASD as one reason for opposition to the NASD-NYSE merger: "[NASD] dissidents are worried they will lose their voice because it will end the NASD's current 'one firm, one vote' policy, which favors small firms"). Such a policy carries with it the reciprocal concern of excluding the interests of the larger firms by diluting their influence in the collaborative process with copious

Policies would have to be enacted either at the level of the government regulator's principles or at the membership organization level to strike the right balance between the representation of interests of small and large players.

CONCLUSION

The regulatory model advocated in this Comment envisions markets that are regulated by collective action of market participants through either groups organized by a government regulator or through membership organizations, all of which is overseen by a single government regulator that guides the markets (through open dialogue and a set of simple principles) and ensures compliance through enforcement of not only its core principles, but also with the rules promulgated by the individual markets.

The example of the Major Dealers initiative in the credit derivatives markets is an archetype for collective action by market participants under the guidance of regulators who allow self-correction of industry-wide problems and self-determination of best practices by those best situated and motivated to deal with those issues. Further, the single government regulator approach of this model finds support in the collaborative efforts of the regulators who take part in the President's Working Group on Financial Markets, which recognizes the need to approach issues from a consolidated rather than fragmented vantage, as well as recent reports that call for reform and consolidation of the U.S. regulatory structure. Together, these two components will further the efficiency of market regulation and U.S. competitiveness, which should be two of the goals for any future model of U.S. regulation that is adopted.