"SHIFTING RISK TO THE DUMBEST GUY IN THE ROOM" – DERIVATIVES REGULATION AFTER THE WALL STREET REFORM AND CONSUMER PROTECTION ACT

Jeremy Gogel[*]

TABLE OF CONTENTS

---

* Law Clerk to the Hon. Philip M. Frazier of the United States District Court for the Southern District of Illinois. Mr. Gogel received a J.D. and M.B.A. from the University of Missouri – Columbia in May, 2009, and dual B.S.B.A.s in Finance & Banking and Economics from the same institution in May, 2006. Prior to his clerkship, Mr. Gogel interned at the United States Commodity Futures Trading Commission's Division of Enforcement and the Office of the Missouri Secretary of State's Securities Division, and volunteered at the Office of the Missouri Attorney General's Consumer Protection Division. While earning his law and graduate business degrees, Mr. Gogel taught an undergraduate course in Corporate Finance at the University of Missouri – Columbia. Financial writer Martin Mayer is credited with the summarization of derivatives quoted in the title of this article.

The purpose of this article is to provide insight into the changing world of derivatives regulation. What follows will hopefully provide an overview of what derivatives are, and how these often complex financial instruments have been – and will be – regulated. The first part of this article will introduce and provide examples of the most common types of derivatives, and explain how these instruments are traded. The second part of this article will discuss the first attempts to regulate derivatives in England and the United States, and how United States regulation has evolved from the short lived Anti-Gold Futures Act of 1864 to the Restoring American Financial Stability Act of 2010. The third part of this article will explain how gaps in prior attempts at derivatives regulation and jurisdictional battles between financial regulators helped lead to the financial crisis of 2008. The fourth part of this article will explain how the Dodd-Frank Wall Street Reform and Consumer Protection Act attempted to fill in some of the previously existing gaps in the derivatives regulations. This article will conclude with an evaluation of the current regulatory regime for derivatives markets.

I. INTRODUCTION

Warren Buffett once famously described derivatives as "financial weapons of mass destruction."[1] Understanding why Mr. Buffett used such strong language to characterize these financial instruments, and why they pose a potential threat to the financial markets, requires an understanding of why derivatives are used, and how they are traded.

A. What Are Derivatives?

A derivative is "a financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity."[2] There is no singular type of derivative instrument, but rather, a family of instruments who derive their values from reference points. These reference points can be currency exchange rates, interest rates set by financial institutions, prices of securities such as stocks or bonds, prices of physical commodities such as precious metals or harvested farm products, or even weather patterns,[3] mortality dates,[4] and, at least for a short period of time in 2010, box office receipts.[5]

The most typical derivative instruments include forward and futures contracts, swaps, and options, and are distinguished by different payment

---

1. BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 15 (2003), http://www.berkshirehathaway.com/2002ar/2002ar.pdf. ("[I] view [derivatives] as time bombs, both for the parties that deal in them and the economic system. . . . The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. . . . Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. . . . In [my] view, . . . derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." *Id.* at 13, 15).

2. Black's Law Dictionary 475 (8th ed. 2004).

3. Various weather derivative products are traded on the Chicago Mercantile Exchange. These products typically derive their values from fluctuations in temperatures. *See* J. Scott Matthews, *Dog Days and Degree Days*, CME GROUP (2009), http://www.cmegroup.com/trading/weather/files/WT133_Weather_White_Paper_Final.pdf; Bob Dischel, *Weather Risk Management at the 'Frozen Falls Fuel Company*, CME GROUP (1999), http://www.cmegroup.com/trading/weather/files/WEA_weather_risk.pdf

4. Cris Sholto Heaton, *Have financial wizards found a way to outwit Death*?, MONEYWEEK (Nov. 24, 2006), http://www.moneyweek.com/investments/have-financial-wizards-found-a-way-to-outwit-death.aspx.

5. On June 14, 2010 and June 28, 2010, the United States Commodity Futures Trading Commission approved the listing and trading of domestic box office receipt futures contracts submitted by Media Derivatives and Cantor Futures Exchange, respectively. Previously, the Commission approved the applications of Media Derivatives and Cantor Futures Exchange, for designation as contract markets. The Restoring American Financial Stability Act, banned the trading of box office derivative contracts. *See* Jeremy Gogel, *The Case for Domestic Box Office Receipt Derivatives*, CHAP. L. REV. (forthcoming 2011).

and/or delivery terms.[6] Futures and options are used for hedging (i.e. shifting the risk of price changes to those who are more willing or able to assume this risk), or for speculation (i.e. investing with the intent of profiting from price changes). Swaps and forwards are typically used to hedge or to obtain more desirable financing. Swaps can be used to speculate but are generally not used as frequently for this purpose because of the relatively high transaction costs compared to those of other derivatives. Thus, only participants willing to operate on a large scale have the potential to make swap speculation worthwhile.

All derivatives fall into two main categories. One category consists of customized, privately negotiated instruments known as over-the-counter ("OTC") derivatives, while the other category consists of standardized, exchange-traded instruments.[7] While many derivative contracts have historically been exchange-traded, the number of OTC derivatives – that is, derivative contracts entered into privately between two parties – far outnumber the size of the exchange-traded contracts market.[8] Exchange-traded contracts and OTC contracts have similar characteristics but differ in some respects. The market values of both are determined, in part, by the value of the underlying asset, reference rate, or index, and both provide users with a means of hedging and/or speculating. However, exchange-traded contracts and OTC contracts differ in the ways that they are entered into and cleared. Exchange-traded contracts are "traded in central locations on the floors of organized exchanges, with clearinghouses assuming the

---

6. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEMS 26 (1994). More complex derivatives can be created by combining the elements of basic derivatives. For example, a swaption gives the holder the option, but not the obligation, to enter into a swap on or before a specified future date. An interest rate cap (or floor) agreement is a derivative in which the buyer receives payments at the end of each period in which the interest rate exceeds (or is below) the specified reference rate.

7. INT'L SWAPS AND DERIVATIVES ASS'N, INC., *Product Descriptions and Frequently Asked Questions*, http://www.isda.org/index.html (click "Education" on left hand side; then click "Product Descriptions & FAQ" and see section 2: "major derivative categories") (last visited Apr. 29, 2010).

8. BANK FOR INT'L SETTLEMENTS, REGULAR OTC DERIVATIVES MARKET STATISTICS (Nov. 12, 2009), http://www.bis.org/publ/otc_hy0911.htm. (The Bank of International Settlements estimates the total notational amount of outstanding OTC contracts at the end of June, 2009 to be $605 trillion. This amount is contrasted with the GAO's estimate of the notational amount of *all* outstanding derivatives contracts (including exchange traded contracts) at the end of the 1992 fiscal year of $12.1 trillion. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, FINANCIAL DERIVATIVES, *supra* note 6, at 34); S. REP. NO. 111-176, 86 (2010) ("By 2008, 59 percent of derivatives were traded over-the-counter, or away from regulated exchanges, compared to 41 percent in 1998.").

responsibility for clearance and settlement."[9] "Clearinghouses manage credit risk . . . by substituting themselves as the buyer to every seller and the seller to every buyer."[10] They also guarantee daily settlement, thereby eliminating the need for the original counterparties to monitor each other's creditworthiness.[11] In contrast, OTC derivatives are usually entered into between a company, as an end-user, and a dealer.[12] The majority of dealers of OTC derivatives are commercial and investment banks.[13] These contracts are more flexible than exchange-traded contracts, "but they suffer from greater counterparty and operational risks and less transparency."[14] Because these transactions are entered into privately, the parties are not locked in to standard exchange traded contract terms, but the "information [available to the parties] on prices and quantities is opaque."[15] The parties' exposure to counterparty risk, in theory, should be addressed through the negotiation of contract terms, but given the relative lack of information, the potential exists for inefficient pricing.[16] Additionally, this "dark market" leaves regulators ill-informed about potential risks building up throughout the financial system.[17] The lack of transparency in the OTC derivatives market intensified fears of exposure to risk during the 2008 financial crisis.[18]

Although the title of this article includes a rather cynical illustration of the derivatives market, there is some truth to this description. Unlike some financial investments (e.g. stocks) which provide all investors with the potential for gains (or losses), in every derivative contract, one party will win, and the other will lose. Examples of how the most common derivatives operate will emphasize this point.

1. *Forward and Futures Contracts*

To illustrate how a forward contract works, imagine that Party A wants to purchase a tractor six months from now, just in time for the harvest season. If Party A went to his local tractor dealer, he might find that the particular model he wants is currently available for $250,000.

---

9. U.S. GOV'T ACCOUNTABILITY OFFICE, COMMODITY EXCHANGE ACT - ISSUES RELATED TO THE REGULATION OF ELECTRONIC TRADING SYSTEMS, GAO-00-99, 6 (2009), *available at* http://www.gao.gov/archive/2000/gg00099.pdf.

10. *Id.*

11. *Id.*

12. Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 BUS. LAW. 1127, 1129-30 (2002).

13. *Id.*

14. S. REP. NO. 111-176, at 89.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

Theoretically, Party A could enter into a contract with the dealer (Party B) whereby Party A would purchase the tractor from Party B in six months for an agreed upon price. Because Party A is purchasing the tractor (also known as the underlying asset), he is said to have entered into a "long" position. Party B, conversely, is said to have entered into a "short" position. One might wonder why anyone would enter into such a contract, when they could simply go down to the dealer in six months and buy the tractor at that time. The reason is, by entering into a forward contract with the dealer, Party A is hedging against the risk that the price of the tractor will go up. In other words, the tractor may sell for $250,000 now, but there is the possibility that some presently unknown economic forces will cause the price of the tractor to increase to $275,000 in six months.[19] Party B, on the other hand, by entering into this contract, is hedging against the risk that the price of the tractor will go down in six months, to say $225,000.[20] Party B is clearly not going to contract to sell you the tractor in six months for $250,000, because there is the possibility that she could sell the tractor now to someone else for $250,000, and invest the proceeds of the sale.[21] In order to reach a price that Party A and Party B will contract for, the dealer must

19. Potential economic forces could include an increase in the cost of raw materials used in manufacturing tractors including the rubber used for tires, the steel used in making the tractor chassis, the plastic used in making the seats, and the glass used in making the windshield. There is also the potential that other costs of manufacturing will increase, including the possibility that workers at the tractor manufacturer will go on strike, either causing the manufacturer to hire replacement workers at a higher wage, pay the striking workers their higher wage demands, or simply shut down production until the strike is resolved, which would create a shortage of tractors available in the market. Each of these potential problems would cause the price of tractors to increase.

20. Factors that could cause the price of tractors to decrease include a drop in the cost of manufacturing the tractors. An additional factor that could cause a decrease in the price of tractors includes a new manufacturer joining the tractor industry. For example, assume there are currently two tractor dealers, each with 5 identical tractors available for sale. If there is a current demand for only 10 tractors, all of the tractors will sell for the dealers' asking price. If, on the other hand, a new company begins manufacturing tractors within the next six months, and creates its own dealer to sell tractors, holding everything else equal, there is the possibility that a surplus of tractors will exist. For instance, in six months, if the existing tractor dealers again have 10 tractors to sell between them, and suddenly, a third dealer pops up with 5 more tractors available to sell, there will be a surplus of 5 tractors for sale, assuming that there is still only a demand for 10 tractors. In order to sell the company's entire inventory, the tractor dealers would lower their prices in an effort to undercut – and hopefully outsell – their competitors.

21. This is an example of "opportunity cost." Opportunity cost is defined as the next best choice among mutually exclusive alternatives. In other words, the tractor dealer has the opportunity to sell the tractor now and invest his proceeds in the bank, but if he decides not to do this, his next best alternative is to sell in six months. By selling in six months without raising the price of the tractor, the dealer is foregoing the potential interest earned on the proceeds of the sale.

determine the interest rate in which she could invest her proceeds.[22] Assuming that Party B could earn a 5% rate of interest compounded daily, after six months, Party B's original $250,000 would now be worth $256,328.34, giving her a six month profit of $6,328.34.[23] It is this amount that Party B needs to be compensated for by foregoing the potential sale of the tractor now. Thus, when the parties enter into a forward contract for a sale in six months for $256,328.34, if the price of the tractor increases to $275,000 in six months, Party A will be the winner, because by entering into the contract, Party A saved himself $18,671.66. If, however, the price of the tractor drops to $225,000, Party B will be the winner, because Party A overpaid by $31,328.34.

Forward contracts are not exchange-traded products. Because there is no central party guaranteeing the contractual performance, the parties to a forward contract are exposed to counterparty risk, which is the risk that the other party to the transaction will fail to perform.

Futures contracts, on the other hand, are similar to forward contracts, except that they are standardized and exchange-traded. Futures contracts generally have settlement dates in the specific months, which means that at a predetermined time in the contract settlement month, the contract stops trading, and a price is determined by the exchange for settlement of the contract.

A party to a futures contract has two choices on how to liquidate its position. The first option is to liquidate the position prior to the settlement date. This option requires the party to take an offsetting position in the same contract. For the buyer of a futures contract, this means selling the same number of identical futures contracts; for the seller of a futures contract, this means buying the same number of identical futures contracts. Alternatively, a party can wait until the contract settlement date. At that time, the party purchasing a futures contract accepts delivery of the underlying asset (e.g. 5,000 bushels of corn, 200,000 lbs. of milk, etc.) or, settlement is made in cash.

---

22. One of the fundamental tenants of personal and corporate finance is "the greater the risk, the greater the reward." Thus, if the dealer invested his funds in equity securities on a newly formed exchange in a developing country, there is a greater possibility that he would lose these funds than if he deposited his proceeds in a savings account at the local bank. Even if the local bank went under, the Federal Deposit Insurance Corporation ("FDIC"), an independent agency of the United States government, will insure depositors against losses. FED. DEPOSIT INS. CORP., FDIC DEPOSIT INSURANCE COVERAGE, http://www.fdic.gov/deposit/deposits/dis/index.html (last visited Apr. 29, 2010). The standard insurance amount is currently set at $250,000 per depositor through December 31, 2013. *Id.* "Since the FDIC was established in 1933, no depositor has ever lost a single penny of FDIC-insured funds." *Id.* In exchange for the decreased risk, though, the local bank will pay a much smaller interest rate than the dealer could *potentially* get by investing on the newly formed exchange.

23. This amount was calculated using a compound factor of 365.24 days.

When a position is taken in a futures contract, the party must deposit a minimum dollar amount per contract as specified by the exchange.[24] This initial margin amount is required as a deposit for the contract and is placed in an account. At the end of each trading day, the exchange determines the settlement price for the futures contract. The settlement price is that value the exchange considers to be representative of trading at the end of the day, and this price will be used to mark the investor's position so that any gain or loss from that position is quickly reflected in the investor's margin account. A maintenance (or variation) margin requirement is the equity amount set by the exchange below which a party's account may not fall.[25] If the equity in a party's margin account fails to meet the maintenance margin requirement, the party will be required to deposit funds in the margin account.[26] Any excess margin in the account may be withdrawn by the party, and if a party fails to deposit the required variation margin, its position will be liquidated.[27] Margin requirements help reduce the counterparty risk between the exchange and the contracting party by providing this liquidity.

2. *Swap Transactions*

A swap transaction is similar to a forward or futures contract, except that it has a multiple period structure with corresponding multiple payments. For instance, in a fixed-for-floating interest rate swap, one party agrees to pay an amount equal to a predetermined fixed interest rate applied to a notional amount, and the other party agrees to pay an amount determined by reference to the value of a specified floating interest rate (e.g., LIBOR[28]) for the applicable period as applied to the same notional amount.[29] The number of periods for which the swap applies is predetermined by the parties.

---

24. *See, e.g.*, CME GROUP, CME FEE SCHEDULE, http://www.cmegroup.com/company/files/CME_Fee_Schedule.pdf (last visited Apr. 29, 2010.).

25. *See, e.g.*, CME GROUP, CME RULEBOOK, RULE 930, PERFORMANCE BOND REQUIREMENTS: ACCOUNT HOLDER LEVEL (Dec. 16, 2008), http://www.cmegroup.com/rulebook/CME/I/9/30.html.

26. *Id.*

27. *Id.*

28. The London Interbank Offer Rate is the rate at which banks borrow funds from other banks in the London interbank market. LIBOR is calculated by the British Bankers' Association (BBA) after 11:00 am every day. Other similar rates include the federal funds effective rate in the United States, the SIBOR rate in Singapore, the TIBOR rate in Tokyo, the FIBOR rate in Frankfort, the PIBOR rate in Paris, and the Euro Interbank Offered Rate (or Euribor) in the European Union.

29. *See* Guinn & Harvey, *supra* note 12, at 1131.

Imagine that Party A owns a bond with a par value[30] of $1000 paying a fixed interest rate of 5% compounded annually. If Party B owns a similar bond paying a floating interest rate tied to the LIBOR, Party B may want to hedge against the risk of the interest rate plummeting and simultaneously guarantee a known, steady stream of income. Party A, on the other hand, may want to trade the guaranteed interest payments for the possibility of larger interest payments. Thus, if the two parties enter into an interest rate swap transaction, when the interest is paid on the two bonds, any interest payments above $50 would have to be paid from Party B to Party A. Conversely, if Party B received less than $50 in interest at the end of the year, Party A would have to pay Party B the difference between what he was actually paid and the $50. Note that Party B will never receive more or less than $50 in this transaction, but Party A has the potential to earn more than $50, as well as the potential to earn less than $50. It should also be clear that ownership of the underlying instruments – in this case, the bonds – never switch hands. Also, while the value of the underlying instrument can be significant (here, the par value of each bond was $1000), the actual amount that changes hands is relatively small.[31]

In addition to fixed-for-floating swaps, parties can enter into fixed-for-fixed swaps, floating-for-floating swaps, or any combination they desire. Parties can also enter into swap transactions where the occurrence of a particular event (e.g. default on mortgage payments)[32] would require clearance and settlement between the parties.[33] Other similar transactions include currency and commodity swaps.

Because of the unique nature of swaps, these types of contracts are entered into OTC.[34] Swaps enjoy higher transactions costs than exchange-

---

30. Par value refers to the face value of the bond. This is the amount that the owner of the bond with be paid on the date of maturity. Thus, if you own a $1000 par value bond that pays 10% interest annually, and will mature in 5 years, you are entitled to 5 payments of $100 every year for the next five years, and additionally, at the end of 5 years, you will be paid $1000. Federal, state, and municipal governments will issue these debt instruments in order to pay for particular projects. They will be sold at a "discount," meaning that the purchaser will pay less than the par value of the bond up front in exchange for a stream of cash flowing down the line.

31. In a fixed for floating swap, the party with the larger obligation on any given settlement date would pay the net amount by which its obligation exceeds the other party's obligation. For example, if Party B was paid $55 in interest on his bond, he would have to pay Party A $5 at the end of the year.

32. *See infra* Part III.a.

33. Clearance is the process of acquiring trade data, comparing buyer and seller versions of the data, and guaranteeing that the trade will settle once the data are matched. Settlement is the process of determining the daily closing price for each contract and collecting losses from clearing members carrying losing positions and making payments to clearing members carrying gaining positions.

34. *See infra* Part II.b.

traded derivatives due to their unique nature, which sometimes require extensive negotiations between the parties.

3. *Option Contracts*

Option contracts give the purchaser the right to buy (referred to as a "call option") or sell (a "put option") a specified asset at a particular price (the "exercise price") on or before a certain future date.[35] In exchange for the right to buy or sell the particular asset, the purchaser pays the seller[36] a certain amount (referred to as the "option premium"). Options are different from forwards and futures contracts in that options do not require the purchaser to buy or sell the underlying asset. Options that expire without being exercised are without value. Thus, a purchaser of an option would lose his option premium if he decides not to exercise the option. Options, like swaps, are settled by the net payment obligations of the parties.[37]

As an example of how an option contract works, imagine that Party A owns one share of stock in XYZ, Corp. Party A sells Party B the right to buy this share for $45 within the next 6 months. The premium on this call option is $5. As soon as the price of XYZ's stock exceeds $50, Party A would be wise to exercise his option and purchase the stock.[38] Depending on the terms of the option contract, there may be a transfer of ownership of the stock from the option writer to the option buyer, or the option writer may merely pay the option purchaser the difference between the exercise price and the market price of the stock at the time the option is exercised.[39] If the price of XYZ's stock drops, Party A would simply let the option expire, and merely have to pay (if he did not do so already) Party B the option premium.

Options, like futures, may be exchange-traded or may be traded OTC like forwards and swaps. The advantages of an exchange-traded option include a standardized exercise price and expiration date, no counterparty

---

35. *See* GOV'T ACCOUNTABILITY OFFICE, FINANCIAL DERIVATIVES, *supra* note 6, at 27.

36. The seller is known as the "writer" of the option contract.

37. *See supra* note 31.

38. This reason $50 is the threshold amount is because the exercise price is $45, and Party B has already paid Party A $5. Therefore, by exercising this option, Party B would "owe" party A a total of $50. Once the price of the stock is greater than $50, Party A could presumably exercise the option, and then turn around and sell the stock for the amount it is worth at that time, and make a profit on the difference between the $50 and the amount the stock subsequently sells for.

39. If the market price of XYZ's stock at the time Party B exercised the option was $52, Party A would have to pay Party B $7 (the difference between the market and exercise prices). Conversely, if Party B was not required to pay Party A the option premium upfront, Party A would have to pay Party B $2 (the difference between the market price and the exercise price plus the option premium).

risk due to the severing of the parties by the exchange, and lower transactions costs. The higher costs of an OTC option, like an OTC swap, reflect the cost of customizing the instrument.

B. Development of Derivatives

While many people consider derivatives to be a recent development, the truth is, they have been around for millennia. Aristotle described the first known options contract in a story of Thales, a philosopher who developed a "financial device, which involves a principle of universal application."[40] Although there is evidence of an emergence of derivative transactions on the Antwerp, Amsterdam, and London exchanges in the 15th and 16th centuries,[41] it was not until the early 18th century that an organized futures exchange appeared in Japan, with rice as the main commodity.[42]

As a result of the chaotic fluctuations in the price of United States. agricultural goods due to unanticipated surpluses and shortages in supply during the 1800s, a market emerged that allowed farmers, processors, and end users to hedge against the potential price variations of these goods. Despite the common use of forward contracts in the early 1800s, most of these contracts were not honored by the losing party. As a result, in 1848, the Chicago Board of Trade ("CBOT") was formed.[43] The first forward contract – on corn – ever recorded was written on March 13, 1851.[44] In 1865, standardized futures contracts for grains were introduced.[45] The Chicago Produce Exchange (later renamed the Chicago Butter and Egg Board) was established in 1874, and then became the Chicago Mercantile Exchange ("CME") in 1919.[46] In 1856 and 1881 respectively, the Kansas

40. THOMAS F. SIEMS, THE CATO INST., 10 MYTHS ABOUT FINANCIAL DERIVATIVES (Sept. 11, 1997), http://www.cato.org/pubs/pas/pa-283.html ("Thales had great skill in forecasting and predicted that the olive harvest would be exceptionally good the next autumn. Confident in his prediction, he made agreements with area olive-press owners to deposit what little money he had with them to guarantee him exclusive use of their olive presses when the harvest was ready. Thales successfully negotiated low prices because the harvest was in the future and no one knew whether the harvest would be plentiful or pathetic and because the olive-press owners were willing to hedge against the possibility of a poor yield.").

41. *See* GEOFFREY POITRAS, THE EARLY HISTORY OF FINANCIAL ECONOMICS, 1478-1776 – FROM COMMERCIAL ARITHMETIC TO LIFE ANNUITIES AND JOINT STOCKS, 1 – 40 (2000).

42. *Id.* at 25.

43. CME GROUP, CME GROUP AT A GLANCE, TIMELINE OF ACHIEVEMENTS http://www.cmegroup.com/company/history/timeline-of-achievements.html (last visited May 3, 2010).

44. *Id.*

45. *Id.*

46. CME GROUP, FROM WATER STREET TO THE WORLD – A BRIEF HISTORY OF THE CHICAGO BOARD OF TRADE AND THE CHICAGO MERCANTILE EXCHANGE (Summer 2007),

City Board of Trade ("KCBT") and the Minneapolis Grain Exchange ("MGEX") were founded to trade primarily in hard red spring wheat futures and options.[47] In 1972, the CME created the International Monetary Market ("IMM") to offer futures contracts in foreign currencies.[48] The creation of the IMM began an explosion of derivatives for non-agricultural products. More recently, the CME has acquired both the CBOT and the New York Mercantile Exchange ("NYMEX") to become the world's largest futures exchange.[49]

II. THE HISTORY OF DERIVATIVES REGULATION

A. Barnard's Act of 1733

In 1733, Sir John Barnard, the Mayor of London, introduced an Act which forbade trading of equity derivative contracts.[50] Barnard sought to outlaw the practice of "stockjobbing."[51] This practice essentially involved a spot sale of stock, with a significant lag time between the sale and the delivery of the security.[52] The difference between the price at the time of the sale (or settlement period) and the price at the time of delivery lead to the creation of potential arbitrage opportunities.[53] The stockjobbing that Barnard sought to outlaw is quite similar to the current practice of options trading of securities.

The main provision of Barnard's Act stated that:

> '[a]ll contracts or agreements whatsoever by or between any person or persons whatsoever, upon which any premium or consideration in the nature of a premium shall be given or paid for liberty to put upon or deliver, receive, accept or refuse any public or joint stock, or other public securities whatsoever, or any part, share

---

http://www.cmegroup.com/company/history/magazine/Summer2007/FromWaterStreetToTheWorld.html.

47. KAN. CITY BOARD OF TRADE, KCBT HISTORY – A CENTURY OF TRADITION, http://www.kcbt.com/history_1.html (last visited May 3, 2010); MINNEAPOLIS GRAIN EXCHANGE, ABOUT MGEX, http://www.mgex.com/about.html (last visisted May 3, 2010).

48. CME GROUP, *supra* note 46.

49. CME GROUP, *supra* note 43.

50. POITRAS, *supra* note 41, at 354.

51. *Id.*; BLACK'S LAW DICTIONARY 1186 (9th ed. 2009) ("Stockjobbing" is defined as "the business of dealing in stocks or shares; esp., the buying and selling of stocks and bonds by jobbers who operate on their own account.").

52. POITRAS, *supra* note 41, at 354-55.

53. *Id.* at 355 ("Initial trading involved establishing a price and paying a small deposit against the future delivery of stock. In cases where the selling broker did have possession of the underlying stock when the transaction was initiated, there was little or no speculative element in the time bargain. However, this was not the case when the seller did not possess the stock. In addition, the purchaser did not usually have to take possession of the stock at delivery but, rather, could settle the difference between the agreed selling price and the stock price on the delivery date.").

> or interest therein, and also all wagers and contracts in the nature of wagers, and all contracts in the nature of puts or refusals, relating to the then present or future price or value of any stock or securities, as aforesaid, shall be null and void.' There was a penalty of £500 on any person, including brokers, who undertook any such endeavor. All bargains were to be 'specifically performed and executed,' stock being actually delivered and cash 'actually and really given and paid', and anyone settling a contract by paying or receiving differences was liable for a £100 penalty. It was further provided that 'whereas it is a frequent and mischievous practice for persons to sell and dispose of stocks and securities of which they are not possessed,' anyone doing otherwise was to incur a penalty of £500.[54]

Despite Barnard's Act making options trading illegal, the practice continued to the point where, in 1820, members of the London Stock Exchange ("LSE") circulated a petition discouraging options trading.[55] The petition passed, and members formally agreed to discourage options trading.[56] However, three years later, when a LSE committee raised a proposal to ban options trading, a substantial number of members voted against it.[57]

Despite Barnard's Act having the distinction of being the first in a long line of attempted regulation of derivatives, it was ultimately a failure due to the lack of enforcement – both by the government and the exchange, – and in 1860, the Act was repealed.[58]

B. The Anti-Gold Futures Act of 1864

On June 17, 1864, Congress enacted the first United States. derivatives regulation when it passed the Anti-Gold Futures Act.[59] The Act was passed in response to the significant discount that the Union's fiat currency – known as the greenbacks – was trading at in comparison to gold.[60] Congress, not willing to accept this result as evidence of poor monetary policy, concluded that it was merely a lack of private market regulation that led to this failure.[61] The Act stated, in part, that:

> it shall be unlawful to make any contract for the purchase or sale and delivery of any gold coin or bullion to be delivered on any day subsequent to the day of making such contract . . . or to make any contract for the purchase or sale and delivery

---

54. *Id.* (*quoting* V. MORGAN AND W. THOMAS, THE STOCK EXCHANGE 62 (1962).
55. *Id.* at 355-56.
56. *Id.* at 356.
57. *Id.*
58. *Id.*
59. Alan Greenspan, Chairman, Fed. Res. Board, Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta: Government Regulation and Derivative Contracts (Feb. 21, 1997) (transcript available at http://www.federalreserve.gov/BoardDocs/Speeches/1997/19970221.htm).
60. *Id.*
61. *Id.*

> of any foreign exchange to be delivered at any time beyond ten days subsequent to the making of such contract . . . .[62]

The Act further provided that "all contracts made in violation of this act shall be absolutely void."[63]

> Any person who violated any provisions of this act shall be held guilty of a misdemeanor, and, on conviction thereof, be fined in any sum not less than one thousand dollars, nor more than ten thousand dollars, or be imprisoned for a period not less than three months, nor longer than one year, or both.[64]

Finally, the Act allowed any individual to bring an action on behalf of the United States against anyone who violated the Act.[65] The individual bringing the suit was entitled to keep one half of the proceeds of the action, with the other half going to the United States.[66]

In 1997, then Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, remarked that the passage of the Anti-Gold Futures Act was "followed by a further sharp drop in the value of the greenbacks. Although it took the government many years to restore monetary policy to a sound footing, it took Congress only two weeks to conclude that its prohibition of gold futures was having unintended consequences and to repeal the act."[67]

The two week period in 1864 during which the Anti-Gold Futures Act stood was the first of only two times in United States history when Congress banned the trading of futures of a specified commodity. The other ban was created by the Onion Futures Act of 1958, which is discussed in part II.f, *infra*.

C. The Futures Trading Act of 1921

After the failure of the Anti-Gold Futures Act, the federal government did not pass any further derivatives regulation until August 24, 1921, when Congress enacted the Futures Trading Act.[68] The Act imposed

> a tax of 20 cents a bushel on all contracts for the sale of grain for future delivery, but excepts from its application sales on boards of trade designated as contract

---

62. Anti-Gold Futures Act of 1864, ch. 127, § 1, 13 Stat. 132 (repealed 1864).
63. Anti-Gold Futures Act § 3.
64. Anti-Gold Futures Act § 4.
65. Anti-Gold Futures Act § 5, 13 Stat. at 132-133.
66. *Id.*
67. Greenspan, *supra* note 60.
68. Futures Trading Act of 1921, ch. 86, 42 Stat. 187 (held unconstitutional by Hill v. Wallace, 259 U.S. 44 (1922)).

> markets by the Secretary of Agriculture, on fulfillment by such boards of certain conditions and requirements set forth in the act.[69]

Under the Act, the Secretary of Agriculture was empowered to designate an exchange as a contract market when the exchange enacted provisions for the prevention of the manipulation of prices and the dissemination of misleading information.[70] Thus, the Act set up a self policing structure for the exchanges – a structure that has continued to present day despite the periodic changes in derivatives legislation.[71]

Soon after the Futures Trading Act was passed, eight members of the CBOT sued to have the Act declared unconstitutional.[72] The members of the CBOT claimed "that the law in effect prohibits all those who are not members of a board of trade . . . from making any contracts of sales for future delivery."[73] The United States Supreme Court noted that between the years of 1884 and 1913, wheat had mostly sold for less than $1 per bushel, corn had mostly sold for less than 60 cents per bushel, and oats had mostly sold for less than 40 cents per bushel.[74] At these prices, a 20 cent tax on every grain futures contract entered into by a non-member of a contract market would, in effect, financially preclude the entering into of such a contract. The CBOT members argued that the Act (1) violated their constitutional right to due process by effectively compelling membership on a board regulated by the Secretary of Agriculture; (2) violated the commerce clause by attempting to regulate intrastate commerce; and (3) violated the Tenth Amendment's principle of federalism by interfering with the right of the State of Illinois to regulate an exchange conducting intrastate transactions.[75]

Chief Justice William Howard Taft, in his opinion in *Hill v. Wallace*, stated that "[t]he act is in essence and on its face a complete regulation of Boards of Trade, with a penalty of 20 cents a bushel on all 'futures' to coerce boards of trade and their members into compliance."[76] "A reading of the act makes it quite clear that Congress sought to use the taxing power to give validity to the act."[77] "[S]ales for future delivery on the Board of Trade are not in and of themselves interstate commerce. They cannot come within the regulatory power of Congress as such, unless they are regarded by Congress, from the evidence before it, as directly interfering with interstate commerce . . . ."[78]

---

69. Hill v. Wallace, 259 U.S. 44, 46 (1922).
70. Futures Trading Act § 5, 42 Stat. at 188.
71. *See infra* Part III.c.
72. Hill, 259 U.S. at 47.
73. *Id.*
74. *Id.*
75. *Id.* at 48.
76. *Id.* at 66 (alteration in original).
77. *Id.* at 68 (alteration in original).
78. *Id.* at 69 (alteration in original).

Ultimately, the Court determined that the grain futures contracts at issue were wholly intrastate transactions, and that the assessment of a 20 cent tax was an unconstitutional exercise of the Congress's taxing power.[79] As a result, the Court declared the entire Act unconstitutional.[80]

D. The Grain Futures Act of 1922

A mere four months after the Supreme Court's decision in *Hill*, Congress passed the Grain Futures Act on September 22, 1922.[81] The purpose of the Grain Futures Act was to regulate interstate transactions[82] on grain futures exchanges. The Act created the Grain Futures Administration within the Department of Agriculture and the independent Grain Futures Commission. The Grain Futures Administration reported grain futures transactions and investigated dissemination of misleading information likely to affect grain prices, while the Grain Futures Commission regulated the grain futures exchanges.[83]

Section 4 of the Act prohibited anyone from using the mail or interstate telephone, telegraphic, wireless, or other communication, in offering or accepting sales of grain for future delivery or to disseminate prices or quotations thereof, except the individual who actually held the grain being sold, the individual who owned or rented the land on which the grain offered for sale was grown, and members of Boards of Trade on which cash sales of similar grains occurred in sufficient volume and under such conditions as to reflect the general value of grain and its different grades, and which have been designated by the Secretary of Agriculture as contract markets.[84] The conditions for becoming and remaining a contract market were:

---

79. *Id.* at 69-70.

80. *Id.* at 70.

81. Grain Futures Act of 1922, ch. 369, 42 Stat 998(1922).

82. Grain Futures Act §2 (In response to the Supreme Court's decision in *Hill v. Wallace*, Congress expressly limited the provisions of the Grain Futures Act to boards of trade and individuals conducting interstate transactions. The Act specifically defined interstate commerce as any transaction where "grain and grain products and by-products thereof are sent from one State with the expectation that they will end their transit, after purchase, in another, including, in addition to cases within the above general description, all cases where purchase or sale is either for shipment to another State, or for manufacture within the State and the shipment outside the state of the products resulting from such manufacture. Articles normally in such current of commerce shall not be considered out of such commerce through resort being had to any means or device intended to remove transactions in respect thereto from the provisions of this act. For the purpose of this paragraph the word 'State' includes Territory, the District of Columbia, possession of the United States, and foreign nation.").

83. NAT'L ARCHIVES AND RECORD ADMIN., RECORDS OF THE COMMODITY FUTURES TRADING COMMISSION, http://www.archives.gov/research/guide-fed-records/groups/180.html (last visisted May 3, 2010).

84. Grain Futures Act § 5.

(a) The keeping of a record with prescribed details of every transaction of cash and future sales of grain of the Board or its member in permanent form for three years, open to inspection of representatives of the Departments of Agriculture and of Justice.

(b) The prevention of the dissemination by the Board or any member of misleading prices.

(c) The prevention of manipulation of prices or the cornering of grain by the dealers or operators on the Board.

(d) The adoption of a rule permitting the admission as members of authorized representatives of lawfully formed co-operative associations of producers having adequate responsibility engaged in the cash grain business, complying with and agreeing to comply with, the rules of the Board applicable to other members, provided that no rule shall prevent the return to its members on a pro rata patronage basis the money collected by such association in the business, less expenses.[85]

A further provision excluded from all contract markets and trading privileges is any person violating the provisions of the act or the regulations in pursuance thereof.

Section 9 of the Act declared that "any one trading futures in violation of section 4, or sending intentionally or carelessly false or misleading quotations or information as to the prices of grain, was guilty of a misdemeanor."[86]

In 1923, the Supreme Court, in another opinion by Chief Justice Taft, addressed the constitutionality of Congress's second attempt to regulate the grain futures market.[87] In *Board of Trade of City of Chicago v. Olsen*, the CBOT argued that the Grain Futures Act violated the commerce clause by attempting to regulate wholly intrastate transactions, just as the Futures Trading Act had done one year earlier.[88]

In distinguishing the two acts, the Court stated that:

> [t]he Grain Futures Act which is now before us differs from the Future Trading Act in having the very features the absence of which we held…prevented our sustaining the Future Trading Act. As we have seen in the statement of the case, the [Grain Futures Act] only purports to regulate interstate commerce and sales of grain for future delivery on boards of trade because . . .manipulation [of these markets] have become a constantly recurring burden and obstruction to [interstate] commerce. Instead, therefore, of being an authority against the validity of the Grain Futures Act, it is an authority in its favor.[89]

The Court continued:

---

85. Bd. of Trade of City of Chi. v. Olsen, 262 U.S. 1, 6 (1923).
86. *Id.* at 7.
87. *Id.*at 31.
88. *Id.* at 32.
89. *Id.* at 32 – 33 (alteration in original).

> [i]t is not the sales and deliveries of the actual grain which are the chief subject of the supervision of [the] . . . Grain Futures Act. . . . It is the contracts of sales of grain for future delivery, most of which do not result in actual delivery but are settled by offsetting them with other contracts….The question is whether the conduct of such sales is subject to constantly recurring abuses which are a burden and obstruction to interstate commerce in grain? And further, are they such an incident of that commerce and so intermingled with it that the burden and obstruction caused therein by them can be said to be direct?
>
> . . . .
>
> In the act we are considering, Congress has expressly declared that transactions and prices of grain in dealing in futures are susceptible to speculation, manipulation, and control which are detrimental to the producer and consumer and persons handling grain in interstate commerce and render regulation imperative for the protection of such commerce and the national public interest therein.
>
> . . . .
>
> . . .Manipulations of grain futures for speculative profit, though not carried to the extent of a corner or complete monopoly, exert a vicious influence and produce abnormal and disturbing temporary fluctuations of prices that are not responsive to actual supply and demand and discourage, not only this justifiable hedging, but disturb the normal flow of actual consignments. A futures market lends itself to such manipulation much more readily than a cash market.[90]

In the end, the Court held that the Grain Futures Act's emphasis on limiting price manipulation in the futures markets – an event which had the potential to adversely affect interstate commerce – was enough to make the Act constitutional under the commerce clause.[91]

E. The Commodity Exchange Act of 1936

The Grain Futures Act remained in effect until June 15, 1936, when Congress passed the Commodity Exchange Act ("CEA"), despite protest by the commodity exchanges and market participants.[92] The CEA amended the Grain Futures Act to add several new sections.[93] The CEA imposed registration requirements on brokers on the floors of exchanges who executed trades on behalf of customers, although it did not seek to regulate individuals trading for their own accounts.[94] The Act also gave the Secretary of Agriculture the power to revoke an exchange's designation as a contract mar-

---

90. *Id.* at 36-37, 39 (alteration in original).

91. *Id.* at 42-43.

92. Community Exchange Act of 1936, ch. 545, 49 Stat. 1491 (1936); Roberta Romano, *The Political Dynamics Of Derivative Securities Regulation*, 14 YALE L.J. ON REG. 279, 313 (1997). ("[t]he CEA was vigorously opposed by the commodity exchanges, including both those already regulated by the Grain Futures Act and those which would be newly subject to it . . . .").

93. *Id.* at 1492 – 1500 (adding sections 4a-i, 5a-b, 6a-b).

94. *Id.* at 1492 –97.

ket.[95] The Commodity Exchange Authority was established,[96] and given the power to set position limits on speculative trading in order to prevent abrupt price swings; however, position limits were not applied to commercial traders, despite the fact that these traders had a history of disrupting the markets.[97] The CEA also extended the Secretary of Agriculture's regulatory jurisdiction beyond grain futures to include futures on other exchange-traded commodities.[98] While the CEA carried forward the Grain Futures Act's prohibition on manipulation, it failed to identify particular practices that would constitute such manipulation, as well as failed to define what the term manipulation meant.[99] Further, the CEA only prohibited fraud in a narrow set of circumstances and did not give the Commodity Exchange Authority the power to adopt rules prohibiting a broader scope of fraud or even to define prohibited fraudulent and manipulative practices.[100]

The Commodity Exchange Authority was an economist driven organization and at one time had only one lawyer on staff.[101] Due, in part, to the lack of enforcement staff, the Commodity Exchange Authority proved relatively ineffective in preventing market abuse. These deficiencies led, in part, to the continual manipulation of various commodity markets between the 1930s and 1970s.[102]

---

95. *Id.* at 1498.

96. The Commodity Exchange Authority was the successor to the Grain Futures Commission. *See Records of the Commodity Futures Trading Commission*, *supra* note 84; Jerry W. Markham, *The Commodity Exchange Monopoly – Reform Is Needed*, 48 WASH. & LEE L. REV. 977, 982 (1991) ("Rather than being an independent federal agency, such as the SEC, the Commodity Exchange Commission was composed of the Secretaries of the Departments of Agriculture and Commerce and the Attorney General of the United States. Day-to-day regulation of the statute was given to the Secretary of Agriculture who assigned this duty to an agency within the department, the Commodity Exchange Authority . . ." (citing H.R.REP. NO. 975 (1974))).

97. Community Exchange Act § 4-5.

98. *Id.* at 1491 (newly regulated commodities included "cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, and [Irish potatoes]"); Markham, *infra* note 99, at 984 ("Ultimately, as trading expanded to such 'world' commodities as coffee, cocoa and sugar, Congress was unable to keep pace with the rapid development of new markets by such piecemeal amendments.").

99. Markham, *infra* note 99, at 982-83.

100. *Id.* at 983 ("The Act prohibited specific trading practices such as 'wash' sales, 'fictitious' trades and 'accommodation' trading, but did not define these terms.").

101. 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, 360 (2003).

102. For an excellent overview of manipulation in various commodity markets during this period, s*ee* Jerry W. Markham, , *Manipulation of Commodity Futures Prices — The Unprosecutable Crime*, 8 YALE J. ON REG. 281, 313 -31 (1991).

F. The Onion Futures Act of 1958

Perhaps the most pervasive manipulation during this period was led by a relatively small number of individuals[103] in the onion markets.[104] As a result of the severe price swings in onions, the CEA was amended in 1955 to give "the Commodity Exchange Authority power to regulate trading in onion futures."[105] As the United States District Court for the Northern District of Illinois later summarized:

> the cash price of onions continued to fluctuate severely and, in 1956, Congress gave consideration to prohibiting trading in onion futures. Hearings were held, and the House Committee on Agriculture concluded that there was a causal relationship between trading in onion futures and fluctuations in the cash price of onions. The Committee recommended that futures trading be prohibited if the futures market could not be operated so as to prevent injury to onion producers. In February 1957, a severe fluctuation in the cash price of onions gave rise to further demands for prohibitive legislation. Hearings were again held, numerous witnesses testified, both for and against prohibition, and the House Committee made the following written findings:
>
> (1) That while there may not be any effect on long-run or season average cash prices of onions resulting from futures trading, there is little doubt but that variations in price on the futures market do have a direct and pronounced effect over short periods of time on cash onion prices.
>
> (2) In contrast to some other commodities where there is wide use of the futures market for hedging purposes by buyers of such commodities, there is relatively little buyer hedging in onion futures.
>
> (3) That a number of growers do make use of futures market and the record shows that there have been few, if any, years when the producer could not at some time during the growing season have hedged his production at a satisfactory price. The record is equally clear, however, that relatively few producers have the financial resources to engage in a substantial hedging operation.
>
> (4) In spite of the improvements in the trading environment which have been brought about as the result of CEA jurisdiction and by action of the Exchange it-

---

103. *Department of Agriculture Appropriations for 1959: Hearings Before A Subcomm. of the H. Comm. on Appropriations*, 85th Cong.1057 – 58 (1958). (In one attempt to manipulate prices, a substantial amount of onions had been sent to Chicago, causing a surplus in the supply of onions which resulted in a significant drop in Chicago onion prices. Meanwhile, the flooding on onions on Chicago caused a shortage of onions in other markets, resulting in significant increases in onion prices in those markets.).

104. *See, e.g,. In re Vincent W. Kosuga*, 19 Ag. Dec. 603 (1960) (The Commodity Exchange Authority alleged upward manipulation of spot market onion prices and onion futures contracts for November and December of 1955 on the CME. The Authority further alleged downward manipulation of spot market onion prices and onion futures contracts for January and February of 1956 on the CME.); B. TAMARKIN, THE NEW GATSBYS: FORTUNE AND MISFORTUNES OF COMMODITY TRADERS 29 (1985) ("[h]ardly a day passed, it seemed, without somebody trying to corner the onion market or squeeze prices higher or push them lower").

105. H.R. REP. NO. 1036, at 2 (1957).

> self, it seems clear that violent fluctuations can still take place on the futures market without any relationship to supply and demand factors and that these price fluctuations can and will have an effect on the cash onion market.'
>
> Accordingly, the House Committee recommended the prohibition of trading in onion futures. The same recommendation was made by the Senate Committee on Agriculture and Forestry which stated in its report:
>
> In 1955, because speculative activity in the futures market was apparently adversely affecting cash onion prices, Congress added onions to the commodities subject to regulation under the Commodity Exchange Act, effective September 24, 1955. This has not cured the situation, however. It now appears that speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions as to require complete prohibition of onion futures trading in order to assure the orderly flow of onions in interstate commerce.
>
> As the Committee Reports indicate, Congress recognized that trading in onion futures was not inherently illegal and that it could serve a useful economic purpose, i.e., hedging. However, Congress also found, on the evidence presented to it, that the speculative aspect of trading in onion futures caused severe and unwarranted price fluctuations and, hence, burdened interstate commerce in onions.[106]

Consequently, on August 28, 1958, Congress passed the Onion Futures Act which banned trading of futures contracts on onions.[107] The passage of the Onion Futures Act was the only time since the failed Anti-Gold Futures Act of 1864 that Congress imposed an outright ban on a specific commodity futures contract.[108] The Act also made it a misdemeanor to enter into an onion futures contract and provided for a maximum fine of $5,000 for a violation of the Act.[109] The Onion Futures Act remains in effect to this day.[110]

G. The Commodity Futures Trading Commission Act of 1974

As a result of the ongoing difficulty in preventing manipulation and fraud in the commodity markets, on October 23, 1974, Congress amended

---

106. Chi. Mercantile Exch. v. Tieken, 178 F.Supp. 779, 781-783 (N.D. Ill. 1959) (alteration in original) (citations omitted) (internal quotation marks omitted).

107. 7 U.S.C. § 13-1(a) (1958).

108. *See supra* Part II.b. While the Shad-Johnson Jurisdictional Accord, discussed in subsection h *infra*, banned the trading of single security futures contracts between 1982 and 2000, this was an outright ban on all security futures contracts rather than a ban on futures contracts of a specific asset.

109. 7 U.S.C. § 13-1(b).

110. Although the Onion Futures Act was intended to stem manipulation in the onion markets, the lack of a futures market has led to volatile price swings of onions over the last 50 years. *See* Jon Birger, *What Onions Teach Us About Oil Prices*, FORTUNE MAGAZINE (June 30, 2008), http://money.cnn.com/2008/06/27/news/economy/The_onion_conundrum_Birger.fortune.

the CEA[111] by passing the Commodity Futures Trading Commission Act of 1974 ("CFTCA").[112] The CFTCA amended the CEA to create an independent regulatory agency – the Commodity Futures Trading Commission ("CFTC")[113] – and granted the CFTC exclusive jurisdiction with respect to "accounts, agreements (including any transaction which is of the character of . . . an 'option'. . . .), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange, or market . . . ."[114] The term "commodity" was statutorily defined to include all "goods and articles, except onions . . . and all services, rights, and interest in which contracts for future delivery are presently or in the future dealt in."[115] In response to the increase in financial derivatives, the CFTCA also included futures contracts for non-agricultural commodities in the CFTC's jurisdictional authority.[116]

With respect to the CFTC's regulatory authority, the CFTCA authorized the CFTC to seek injunctive relief to prevent CEA violations from occurring.[117] Additionally, whenever the CFTC or an exchange had reason to believe that an "emergency"[118] existed, the CFTCA authorized either to take action in order to restore orderly trading.[119] Additionally, exchanges were encouraged to enforce the self-imposed rules authorizing the discipline of their members and report any disciplinary actions to the CFTC, which could affirm, modify, or set aside the action. [120]

---

111. *See* S. REP. NO. 93-1131, at 1 (1974) ("H.R. 13113 makes extensive changes in the Commodity Exchange Act, brings under Federal regulation all agricultural and other commodities, goods, and services traded on exchanges, and otherwise strengthens the regulation of the Nation's $500 billion commodity futures trading industry. The bill is designed to further the fundamental purpose of the Commodity Exchange Act in insuring fair practice and honest dealing on the commodity exchanges and providing a measure of control over those forms of speculative activity which often demoralize the markets to the injury of producers, consumers, and the exchanges themselves.").

112. Commodity Futures Trading Act of 1974 §201, Pub. L. No. 93-463, 88 Stat 1389 (1974).

113. The CFTC was formed by merging the Commodity Exchange Authority and the Commodity Exchange Commission. *See* NAT'L ARCHIVES & RECORD ADMIN., *supra* note 84.

114. 7 U.S.C. § 2(a)(1)(A) (1974).

115. 7 U.S.C. § 1a(4) (1974) (alteration in original).

116. Commodity Futures Trading Act § 201, *supra* note 115, at 1395.

117. 7 U.S.C. § 13a-1 (1974).

118. 7 U.S.C. § 12a(9) (1974) ("The term 'emergency' as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity.").

119. *Id.*

120. 7 U.S.C. § 12(c).

Criminal penalties for market manipulations were increased from $10,000 to $100,000,[121] and authority was granted to impose civil penalties of up to $100,000 for each violation of the CEA.[122] Just as Congress had done with the amendment of the Grain Futures Act in 1936, the CFTCA carried forward the prohibitions on market manipulation but nonetheless failed to identify particular practices that constituted manipulation or define the term manipulation.[123]

Before the Dodd Frank Wall Street Reform and Consumer Protection Act, the amended CEA required exchanges to submit proposals of new bylaws, rules, regulations, and resolutions related to futures contracts or trading requirements to the CFTC for approval.[124] The CFTCA also provided for the creation of self-regulatory organizations known as registered futures associations.[125]

Despite the creation of the CFTC and the increased regulatory power it was given in comparison to that of its predecessor agencies, manipulation still ran rampant in the commodity markets throughout the remainder of the 1970s and 1980s.[126] Although there had been a call for increased regulation after the passage of the CEA,[127] very few significant changes were made to the Act for the next 26 years.[128] The 1992 amendment of the CEA, known as the Futures Trading Practices Act, allowed the CFTC to exempt OTC derivatives from CFTC regulations – a decision that would attract an increasing number of critics in the coming years.[129]

---

121. 7 U.S.C. § 13(b).

122. 7 U.S.C. § 9 (1974).

123. *See* Markham, *supra* note 105, at 380 n.369 ("This was not the only definitional omission. Although Congress did define certain terms in the Commodity Exchange Act, it did not define what the Act seeks to regulate, *i.e.*, it did not define what a commodity futures contract is. This has led to much regulatory confusion and uncertainty") (citations omitted).

124. 7 U.S.C. §§ 7a(a)(1) – (12) (1974) (repealed by Dodd Frank Wall Street Reform and Consumer Protection Act, P.L. 111—203, 124 Stat. 1376 (2010)).

125. 7 U.S.C. § 21 (1974).

126. *See* Markham, *supra* note 105, at 334-58 (discussing manipulation in the potato, coffee, wheat, soybean, silver, cattle, and corn markets during this time period.).

127. *Id.* at 379.

128. The CEA was amended five times over the next 21 years in hopes of strengthening its provisions. *See* Futures Trading Act of 1978, Pub. L. No. 95-405, 92 Stat. 865 (1978); Futures Trading Act of 1982, Pub. L. No. 97-44, 96 Stat. 2294 (1983); Futures Trading Act of 1986, Pub. L. No. 99-641, 100 Stat. 3556 (1986); Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat 3590 (1992); CFTC Reauthorization Act of 1995, Pub. L. No. 104-9, 109 Stat. 154 (1995). A discussion of the Shad-Johnson Jurisdictional Accord, which was codified in the Futures Trading Act of 1982, is discussed in section h, *infra*.

129. 7 U.S.C. § 6(c)(1) (1992) ("In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order . . . may (on . . . application of any person . . .) exempt any agreement, contract, or transaction (or

H. The Commodity Futures Modernization Act of 2000

On December 15, 2000, the House of Representatives, by a vote of 292 to 60,[130] and the Senate, by unanimous consent,[131] passed the Commodity Futures Modernization Act of 2000 ("CFMA"). The purpose of the CFMA included the promotion of "innovation for futures and derivatives and . . . [the reduction of] systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions; . . .[and providing] 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."[132]

The CFMA exempted from all provisions of the CEA any agreement, contract, or transaction in a commodity other than an agricultural commodity that was (i) entered into by eligible contract participants,[133] (ii) "subject to individual negotiation by the parties,"[134] and (iii) not executed or traded on a trading facility.[135] Also excluded from regulation under the CEA were transactions in excluded commodities[136] that were (i) entered into

---

classes thereof) . . . otherwise subject to subsection (a) (including any person or class of persons offering, entering into, or rendering advice . . . with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods . . . from any of the requirements of subsection (a) . . . or from any other provision of this chapter (except . . . section 2(a)(1) . . .,) if the Commission determines [, after notice and opportunity for hearing,] that the exemption would be consistent with the public interest.").

130. 106 CONG. REC., H12502 (2000).

131. SANDY STREETER, CONG. RESEARCH SERV., CONTINUING APPROPRIATIONS ACTS: BRIEF OVERVIEW OF RECENT PRACTICES (2000) (in footnote b to Table 1, the report states that "a unanimous consent request is proposed to adopt the measure and if no Member objects, the resolution is adopted."); 106 CONG. REC., S11876 (2000) (Senator Paul Wellstone, rising in opposition to the passage of the bill stated that the omnibus bill in which the CFMA was included "is being passed by the Senate tonight under a consent agreement.").

132. H.R. 4541, 106th Cong. (2000) (alteration in original).

133. 7 U.S.C. § 2(g)(1) (2010). In 2008, the CEA was amended to define eligible contract participants as organizations that: (i) have more than $10 million in assets, or (ii) have a net worth of more than $1 million and enter into the transaction for risk management purposes. Federal, state, and foreign governmental entities qualify as eligible contract participants if they: (i) qualify as eligible commercial entities, (ii) own and invest on a discretionary basis $25 million or more in investments, or (iii) enter into a transaction with a regulated dealer. Individuals qualify as eligible contract participants if: (i) they have total assets in excess of $10 million, or (ii) they have total assets in excess of $5 million, and enter into the transaction for risk management purposes. The CFTC can designate other individuals or organizations as eligible contract participants on a case by case basis. 7 U.S.C. §2(c)(2)(B) (2008).

134. 7 U.S.C. § 2(g)(2).

135. *Id.* at § 2(g)(3).

136. An "excluded commodity" includes (i) an interest rate, exchange rate, currency, security, security index, . . . or other macroeconomic index or measure; (ii) any other rate, differential, index or measure of economic or commercial risk, return or value that is (I) not

by eligible contract participants[137] and (ii) "not executed or traded on a trading facility."[138] In essence, these additions to the CEA allowed OTC derivatives to be negotiated between wealthy individuals or organizations, without being subject to regulation in contrast to the stated intention of the CFMA.

The CFMA also created a three-tiered regulatory framework consisting of the contract markets that had existed since the Grain Futures Act of 1922, less regulated organized markets known as derivatives transaction execution facilities ("DTEF"), and unregulated or exempt derivatives markets. Many exchanges were still required to seek and maintain a "contract market" designation, but the CFMA created a framework of "core principles"[139] that these individual boards of trade were required to comply with in order to maintain this designation.[140] The newly created DTEFs were subjected to a less comprehensive body of core principles[141] than contract markets, but in exchange for the less stringent regulatory oversight, were limited in the types of commodities it could offer, as well as the types of parties who were allowed to participate in the transactions.[142] In addition to

---

based in substantial part on the value of a narrow group of commodities not described in clause (i); or (II) is based solely on one or more commodities that have no cash market; (iii) any economic or commercial index based . . . on values or levels that are not within the control of any party to the relevant . . . transaction; or (iv) an occurrence, extent of an occurrence or contingency . . . beyond the control of the parties . . . and associated with a financial, commercial or economic consequence. 7 U.S.C. § 1(a)(13) (2010).

137. 7 U.S.C. § 2(h)(A) (2002).

138. 7 U.S.C. § 2(d)(1). This exclusion applies even if the transaction is submitted to an organization for clearing and settlement. Some indirect oversight over these transactions still occurred, though, because certain clearing organizations known as "multilateral clearing organizations" were still subject to banking regulations, and other clearing organizations known as "derivative clearing organizations" were required to register with, and were subject to regulation by, the CFTC.

139. 7 U.S.C. §§ 7(d)(2) – (18) (2010) (the 17 core principles contract markets are subject to include: (1) compliance with rules; (2) acceptable products; (3) monitoring of trading; (4) position limits; (5) emergency authority; (6) disclosure of information; (7) trading data dissemination; (8) execution of transactions; (9) trade information maintenance; (10) financial integrity; (11) protection of market participants; (12) dispute resolution; (13) fitness standards; (14) conflicts of interest; (15) governance of mutually owned markets; (16) recordkeeping; (17) antitrust considerations.).

140. 7 U.S.C. § 7(d)(1) ("To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.").

141. 7 U.S.C. §§ 7a(d)(2) – (10) (the 9 core principles DTEFs are subject to include: (1) compliance with rules; (2) monitoring of trading; (3) position limitations or accountability; (4) disclosure of information; (5) trading data dissemination; (6) fitness standards; (7) conflicts of interest; (8) recordkeeping; and (9) antitrust considerations.).

142. 7 U.S.C. §§ 7a(a) – (b) (If access to a DTEF is limited to eligible commercial entities trading for their own accounts, the DTEF may permit trading involving any commodity other than an agricultural commodity, and if access to a DTEF is not so limited, transactions are restricted to contracts where: "(A) the underlying commodity has a nearly

DTEFs, the CFMA authorized the creation of "exempt boards of trade"[143] ("exempt boards") and "excluded electronic trading facilities"[144] ("EETF"). The exempt board and EETF provisions of the CFMA provided a means for establishing trading facilities for certain derivative transactions (e.g. energy, metal, chemical, and emissions futures) that were largely outside the scope of the CFTC's regulation, with the exception that exempt boards were subject to the anti-fraud and anti-manipulations prohibitions of the CEA. However, EETFs, were not subject to these prohibitions.

Before passage of the CFMA, contracts could not be listed on an exchange unless the CFTC determined that they satisfied an economic purpose.[145] This standard required that exchanges demonstrate that a proposed contract could be used for hedging or price basing.[146] Although the CFMA still gave the CFTC authority over the listing of new contracts for trading, products could now be listed unless the CFTC determines that they "would violate" the CEA.[147] However, the CFMA amended the CEA to allow contract markets to list contracts as long as they were not readily susceptible to manipulation.[148] In contrast, the core principles applicable to DTEFs did not include a similar anti-manipulation provision.[149] Essentially, the burden shifted from exchanges being required to establish why a contract should be listed, to the CFTC being required to establish why a contract should not be listed.

---

inexhaustible deliverable supply; (B) the underlying commodity has a deliverable supply that is sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation; (C) the underlying commodity has no cash market; (D)(i) the contract is a security futures product, and the [DTEF] is a national securities exchange registered under the Secutiries Exchange Act of 1934; or (E) the Commission determines, based on the market characteristics, surveillance history, self-regulatory record and capacity of the facility that trading in the contract . . . is highly unlikely to be susceptible to the threat of manipulation." (citation omitted) (alteration in original)).

143. 7 U.S.C. § 7a-3 **(**transactions conducted on an exempt board must be between eligible contract participants. Permissible transactions for an exempt board of trade are limited to transactions for which the underlying commodity has: "(A) a nearly inexhaustible deliverable supply; (B) a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, to render any contract traded on the commodity highly unlikely to be susceptible to the threat of manipulation; or (C) no cash market." Transactions on an exempt board are subject to the anti-fraud and anti-manipulation provisions of the CEA.).

144. 7 U.S.C. § 2d(2) (2000) (the CEA does not apply to contracts (i) entered into only by eligible contract participants trading on a principal-to-principal basis or in certain investment management or fiduciary capacities, and (ii) done so on an electronic trading facility.).

145. 7 U.S.C. § 7(a) (1992) (Futures contracts must be "sold in sufficient volumes and under such conditions as fairly to reflect the general value of the commodity and the differences in value between the various grades of such commodity.)".

146. 7 U.S.C. § 7(d) (2010).

147. 7 U.S.C. § 7a-2(c)(3).

148. 7 U.S.C. § 7(d)(3).

149. *See supra* note 144.

The CFMA's relaxed regulatory theme was carried through to the amended CEA listing requirements, which now allows exchanges to choose between listing contracts pursuant to a self-certification procedure or pursuant to a prior review procedure by the CFTC.[150] By filing a self-certification, an exchange certifies that the contract complies with the CEA and is required to submit the certification documents to the CFTC no later than one business day before initial implementation of the product listing.[151] The CFMA made it possible, therefore, for trading to occur on contracts that are subsequently banned by the CFTC, merely by self-certifying the contract in good faith. If prior approval of a contract is sought, the exchange must submit to the CFTC the contract's terms and conditions and demonstrate compliance with CFTC regulations.[152] Products submitted for prior approval were subject to a 45 day review period, with the potential for a 45 day extension if the product raises a "novel or complex" issue.[153]

Finally, the CFMA allowed trading in single security futures contracts[154] under the regulation of both the CFTC and the Securities and Exchange Commission ("SEC"). This amendment repealed the longstanding ban on single security futures contracts established by the Shad-Johnson Jurisdictional Accord ("Accord").[155] The Accord was an agreement reached between the Chairmen of SEC and CFTC to resolve a dispute concerning jurisdiction over securities-based derivatives. Under the Accord, the CFTC retained exclusive jurisdiction over all futures contracts

---

150. 7 U.S.C. § 7a-2(c).

151. 17 C.F.R. § 40.2 (2009).

152. 17 C.F.R. app. A at pt. 40 (2009).

153. 17 C.F.R. § 40.3(c)(1) (2009).

154. 7 U.S.C. § 1a(32) (2000) ("The term 'security futures product' means a security future or any put, call, straddle, option, or privilege on any security future.").

155. The Shad-Johnson Jurisdictional Accord, Pub. L. No. 97-303, 96 Stat. 1409 (1982), was the result of an agreement between the Commodity Futures Trading Commission's Chairman, Phil Johnson, and the Securities and Exchange Commission's Chairman, John Shad, to clarify jurisdictional concerns between the two agencies and their respective products. *See* U.S. GOV'T ACCTOUNTABILITY OFFICE, GAO-00-89, CFTC AND SEC – ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD 6 (2000) *available at* http://www.gao.gov/archive/2000/gg00089.pdf ("The accord . . . provided SEC with jurisdiction over securities-based options, including stocks and stock indexes. Second, the accord prohibited futures (and options thereon) on single corporate and municipal securities. . . . Finally, the accord provided CFTC with jurisdiction over futures (and options thereon) on exempted securities (other than municipal securities) and stock indexes. The accord allowed CFTC to approve a stock index futures contract for trading if CFTC found that the contract was (1) settled in cash; (2) not readily susceptible to manipulation; and (3) based on an index that either was a widely published measure of and reflected the market as a whole or a substantial segment of the market, or else was comparable to such a measure. According to SEC and CFTC, these three standards were intended to ensure that stock index futures would not be readily susceptible to manipulation, be used to manipulate the underlying securities or related options markets, or serve as a surrogate for a single stock futures contract.").

and options on both futures contracts and physical commodities.[156] The CFTC was also given jurisdiction over options on foreign currencies not traded on national securities exchanges, futures, and options on futures on securities indexes and exempted securities.[157] The accord allowed the CFTC to approve a stock index futures contract for trading if it "was (1) settled in cash; (2) not readily susceptible to manipulation;" and (3) derived from a substantial segment of a publicly traded group or index of equity or debt securities, called broad-based indexes.[158] These contracts were also subject to initial SEC review for compliance with these requirements, and the SEC was given the authority to prohibit the trading of these contracts if the SEC determined that these requirements were not met.[159] Also under the Accord, the SEC retained jurisdiction over securities, including options on: (1) securities, (2) certificates of deposit, (3) securities indexes, and (4) foreign currency traded on a national securities exchange.[160] Because the two agencies could not resolve their jurisdictional differences with respect to single security futures contract, these contracts were banned for nearly 20 years between the adoption of the Accord and the passage of the CFMA.

On the heels of the prosperous late 1990s on Wall Street, there was little opposition to the CFMAs deregulatory tenor. During this time, however, the CFTC began looking deeper into OTC derivatives regulation.[161] Former CFTC Chairwoman, Brooksley Born, was concerned that unregulated trading in derivatives had the potential to threaten commodity markets, or even the economy as a whole.[162] Born's views were fiercely opposed by Former Federal Reserve Chairman Alan Greenspan and Treasury Secretary Robert Rubin.[163] Most financial regulators during this time were not concerned about the lack of regulation in the OTC derivatives market because the belief was that these instruments did not pose a significant threat to the financial system. OTC derivatives had been viewed as being less susceptible to price manipulation and as not serving a significant price discovery function.[164] The battle was so intense that in November of 1999, certain financial regulators – including Greenspan and Rubin – recommended that

---

156. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-00-89.

157. *Id.* at 6 n.13 ("Exempted securities include securities issued or guaranteed by the United States, the District of Columbia, or any U.S. state.").

158. *Id.* at 6.

159. *Id.* at 7.

160. *Id.* at 6 n.12.

161. Peter S. Goodman, *The Reckoning – Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html.

162. *Id.*

163. *Id.*

164. U.S. GOV'T ACCOUNTABILITY OFFICE, COMMODITY EXCHANGE ACT, *supra* note 9.

Congress permanently strip the CFTC of regulatory authority over derivatives.[165] As a result of the combination of a booming financial market and the request of perhaps the most beloved Federal Reserve Chairman of all time, the CFMA was passed. It would take another 8 years before some – but not all – of the holes in the bill were patched.

I. The Farm Bill of 2008

On June 18, 2008, the Food, Conservation, and Energy Act of 2008 ("Farm Bill") was passed by Congress.[166] In addition to reauthorizing the CFTC through 2013, the Farm Bill reversed the provisions in the CFMA that exempted the CFTC jurisdictional authority from energy contracts traded on EETFs.[167] This gap in the CFMA became known as the "Enron Loophole" because prior to the dissolution of the fallen energy trading giant, Enron was one of the companies that took advantage of this gap in the CFTC's regulatory authority. The Farm Bill closed this loophole by providing the CEA with a new definition of a "trading facility"[168] and by imposing a requirement that EETFs meet core principles substantially similar to those of DTEFs.[169] The Bill also subjected EETFs to CFTC position limits, recordkeeping requirements, and large trader reporting requirements if the CFTC determined that an exempt board was trading a "significant price discovery contracts" ("SPDC").[170] The Farm Bill defined a SPDC as a contract traded on an otherwise exempt EETF "that has a price linkage to contracts traded on a regulated contract market, or is used as a material price reference to price transactions in the underlying commodity."[171] The Farm

165. *Id.*

166. The Food, Conservation, and Energy Act of 2008, Pub. L. 110-246, 122 Stat. 1651 (2008); *See Congress Passes Farm Bill Over Bush Veto*, CNN (June 18, 2008), http://www.cnn.com/2008/POLITICS/06/18/farm.bill/index.html?iref=allsearch (The Farm Bill was originally passed over a presidential veto on May 22, 2008, but because of a clerical error, one of the titles in the bill was omitted in the version vetoed by the President. Congress voted to present a complete version of the legislation to the President, and it was passed over another veto on June 18, 2008.).

167. 7 U.S.C. § 2(h) (2008).

168. 7 U.S.C. § 1a(34) (2008).

169. 7 U.S.C. § 2(h)(7)(C)(ii) (The nine core principles EETFs are subject to include: (1) contracts not susceptible to manipulation; (2) monitoring of trading; (3) ability to obtain information; (4) position limitations or accountability; (5) emergency authority; (6) trading data dissemination; (7) compliance with rules; (8) conflicts of interest; and (9) antitrust considerations.).

170. 7 U.S.C. § 2(h)(7) (2008).

171. 7 U.S.C. § 2(h)(7)(B); Jerry W. Markham, *Merging the SEC and CFTC – A Clash of Cultures*, 78 U. CIN. L. R. 537, 586 – 87 (2009).

Bill amendments now require EETFs to comply with core principles, similar to those imposed by the CFMA on DTEFs.[172]

In addition to closing the Enron Loophole, the Farm Bill clarified the CFTC's regulatory authority over foreign exchange contracts.[173] These provisions were necessary because in 2004, the 7th Circuit Court of Appeals adopted a relatively narrow definition of the phrase "contracts of sale of a commodity for future delivery," over which the CFTC has regulatory authority.[174] The Court noted that the CFMA modified the CEA to allow the agency to enforce the anti-fraud and anti-manipulation provisions of the Act with respect to currency futures contracts.[175] However, the transactions at issue in *Zelener* involved spot sales of foreign currency for delivery within 48 hours.[176] The Court disagreed with the CFTC's argument that the 48 hour lag essentially created a futures contract and held, therefore, that the transactions were outside the CFTC's jurisdiction.[177] In response to the Court's decision in *Zelener*, the CEA was amended to grant the CFTC regulatory authority over off-exchange retail foreign exchange transactions.[178]

Despite the Farm Bill's patch of the Enron Loophole and clarification of the CFTC's authority over foreign exchange contracts, it failed to address the issue of OTC derivatives regulation. A mere three months after the passage of the Farm Bill, the collapse of the United States financial system revealed the fragility of an unregulated OTC derivatives market.

J. Jurisdictional Battles Between Financial Regulators

The CFTC is not the only regulator of the derivatives markets. In addition to the CFTC, the exchanges themselves have self-imposed rules that they are encouraged to strictly enforce. Additionally, the National Futures Association ("NFA") is an industry wide, self-regulatory organization ("SRO") of the United States futures industry. For the most part, these SROs work together with the CFTC to regulate the futures

---

172. Markham, *infra* note 174, at 587 ("[A]mong other things, [the CEA now requires exempt boards] to take steps to prevent price manipulation, provide information to the CFTC upon request, adopt rules imposing speculative position limits, and publish daily price and volume information on SPDs. Large traders on an [exempt board] trading in SPDs are also required to report their trades to the CFTC.").

173. 7 U.S.C. § 2(c)(2)(B).

174. Commodity Futures Trading Com'n v. Zelener, 373 F.3d 861, 862 (7th Cir. 2004).

175. *Id.*

176. *Id.* at 863.

177. *Id.* at 869.

178. 7 U.S.C. § 2(c)(2)(B).

markets and participants. However, the CFTC's largest "rival" in the derivatives regulation industry is the SEC.

The jurisdictional battle between the CFTC and SEC, over which agency has the authority to regulate certain derivative transactions, has existed since the creation of the CFTC in 1974.[179] The conflict originates from Congress's extensive grant of jurisdiction to the CFTC when it passed the CFTCA.[180] The broad jurisdictional grant potentially places certain derivative transactions that might otherwise be within the regulatory reach of the SEC, under the CFTC's jurisdictional authority.[181] Moreover, the exclusive jurisdiction clause of the CEA, granting the CFTC regulatory authority over contracts of commodities for future delivery, arguably preempts other regulatory agencies, such as the SEC, from regulating instruments that would fall within the CEA's statutory definition of a commodity.

Despite the various amendments to the CFTCA over the past 35 years, the jurisdictional battles between the CFTC and SEC have continued. At no time was this battle more intense than during the mid to late 1990s when the two agencies failed to agree on how to regulate OTC derivatives.[182] The CFMA ultimately failed to clarify jurisdictional authority over OTC

---

179. Willa E. Gibson, *Are Swap Agreements Securities or Futures? The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 IOWA J. CORP. L. 379, 388 (1999).

180. 7 U.S.C. § 2(a)(1)(A) (The CEA currently gives the CFTC "exclusive jurisdiction . . . with respect to accounts, agreements [including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty'], and transactions involving contracts of sale of a commodity for future delivery (including significant price discovery contracts), traded or executed on a [designated] contract market . . . or derivatives transaction execution facility.").

181. The Commodity Exchange Act of 1974, Pub. L. 93-463, 88 Stat 1389, 1395 (1974) (The CFTCA amendments to the CEA explained the coverage of the statute to include non-agricultural commodities "in which contracts for future delivery are presently or in the future dealt in." This potentially placed derivatives contracts for securities under the regulatory authority of the CFTC. This potential regulatory conflict led to the 1982 Shad-Johnson Accord, see *supra* note 157, which banned trading of single stock futures contracts. It would take another 18 years until the CFMA authorized trading of these financial instruments, see *supra* note 156.

182. *See* Ted Bunker, *Power Grab Threatens OTC Derivatives Market*, BOSTON HERALD (June 22, 1998); Gibson, *infra* note 182, at 390-93 (In 1997, the SEC proposed a rule to allow broker-dealers selling OTC derivatives to establish designated subsidiaries for their OTC transactions in the U.S. The subsidiaries would be allowed to register with the SEC as an alternative to registration as a fully regulated broker-dealer under Section 15(b) of the Exchange Act if they combine their business in securities and non-securities OTC derivatives products. The CFTC responded by saying that the proposed rule infringed upon the CFTC's jurisdictional authority over OTC derivatives transactions, because only a small percentage of OTC derivatives involved securities. Nonetheless, the rule took effect on January 4, 1999.).

derivatives – a decision that would ultimately haunt the United States and world financial markets in the years to come.

III. THE 2008 FINANCIAL CRISIS

On October 8, 2008, Christopher Cox, then Chairman of the SEC, characterized the lack of oversight of the OTC derivatives market as a "regulatory black hole."[183] Chairman Cox was certainly not the first to point out the lack of regulation in the OTC derivatives market. In a 1994 report by the United States Governmentl Accountability Office ("GAO"),[184] the Comptroller General of the United States stated:

> [g]iven the weaknesses and gaps that impede regulatory preparedness for dealing with a crisis associated with derivatives, GAO recommends that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers. Regulators should attempt to prevent financial disruptions from turning into crises and resolve crises to minimize risks to the financial system. . . . The immediate need is for Congress to bring the currently unregulated OTC derivatives activities of securities firm and insurance company affiliates under the purview of one or more of the existing federal financial regulators and to ensure that derivatives regulation is consistent and comprehensive across regulatory agencies.[185]

A. Credit Default Swaps

One of the leading factors of the 2008 financial crisis was the use of an OTC derivative instrument called a credit default swap ("CDS"). CDSs are bilateral, privately negotiated contracts used to transfer risk between protection buyers and protection sellers.[186] As one recent commentator stated, "CDSs have provided an important tool for risk management. They enable banks and other financial institutions to hedge the credit risk of lending to corporations, in turn facilitating economic activity. Hedging credit risk arguably frees up funds to be lent elsewhere, making more capital

---

183. Christopher Cox, Chairman, SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008) (transcript available at http://www.sec.gov/news/speech/2008/spch100808cc.htm).

184. "Effective July 7, 2004, the [General Accounting Office's] name became the Government Accountability Office. The change, which better reflects the modern professional services organization GAO has become, is a provision of the GAO Human Capital Reform Act of 2004, Pub. L. 108-271, 118 Stat. 811 (2004)." *How GAO Built its Dream House*, GOV'T ACCOUNTABILITY OFFICE http://www.gao.gov/about/history/building.html (last visited May 3, 2010).

185. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 6, at 26 (alteration in original).

186. DAVID MENGLE, FED. RES. BANK OF ATLANTA, CREDIT DERIVATIVES: AN OVERVIEW, ECONOMIC REVIEW (2007), http://www.frbatlanta.org/filelegacydocs/erq407_mengle.pdf.

available for financings, which can reduce the cost of borrowing."[187] CDSs were invented by Wall Street Banks in the late 1990s, but the size of the market is estimated to have increased from a notional value of $632 billion in 2001, to over $54.6 trillion in notional value by mid 2008.[188]

In a CDS transaction, one party, the protection buyer, pays a periodic fee to another party, the protection seller, during the lifespan of the CDS. If a designated credit event occurs (e.g. a default on a mortgage), the protection seller must compensate the protection buyer for the loss by means of a process called settlement. "The terms of an individual CDS transaction are documented in a 'confirmation' that incorporates the master agreement, schedule, and credit support annex," and because these are privately traded instruments, outside parties are not privy to the specific terms.[189]

Just like with any other derivative instrument, the reference entity for a CDS is not a party to the contract, and the buyer or seller need not obtain

---

187. *Id.*; *See* Gary Gensler, Commodity Futures Trading Comm'n, Keynote Address: OTC Derivatives Reform, Market's Outlook for OTC Derivatives Markets Conference (March 9, 2010) (transcript available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-32.pdf) ("Though credit default swaps have existed for only a relatively short period of time, the debate they evoke has parallels to debates as far back as 18th Century England over insurance and the role of speculators. English insurance underwriters in the 1700s often sold insurance on ships to individuals who did not own the vessels or their cargo. The practice was said to create an incentive to buy protection and then seek to destroy the insured property. It should come as no surprise that seaworthy ships began sinking. In 1746, the English Parliament enacted the Statute of George II, which recognized that 'a mischievous kind of gaming or wagering' had caused 'great numbers of ships, with their cargoes, [to] have . . . been fraudulently lost and destroyed.' The statute established that protection for shipping risks not supported by an interest in the underlying vessel would be 'null and void to all intents and purposes.'").

188. *See* MENGLE, *infra* note 189, at 7; INT'L SWAPS AND DERIVATICES ASS'N, INC., ISDA MID-YEAR 2008 MARKET SURVEY SHOWS CREDIT DERIVATIVES AT $54.6 TRILLION (2008), http://www.isda.org/press/press092508.html; Robert Pickel, Chief Exec. Officer, Int'l Swaps and Derivatives Ass'n, Inc., TESTIMONY BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS UNITED STATES SENATE (Mar. 10, 2009) (transcript available at http://www.isda.org/press/pdf/Testimony-of-Robert-Pickel031009.pdf) ("While using notional amount as a measurement tool for the size of the privately negotiated derivatives business has its benefits, it also has a major drawback. Notional amount greatly overstates the actual exposure represented by the CDS business. One reason for this is because a seller of protection often seeks to hedge its risk by entering into offsetting transactions. Using the example above, if the counterparty that sold $10 million of protection wished to hedge its risk and buy protection, it too would enter into a $10 million CDS contract. Thus, there are now two CDS contracts outstanding with a total notional amount of $20 million. The reality is, however, that only $10 million is at risk.").

189. Janis Sarra, *Financial Market Destabilization and the Role of Credit Default Swaps: An International Perspective on the SEC's Role Going Forward*, 78 U. CIN. L. REV. 629, 632 (2009).

the reference entity's consent in order to enter into a transaction.[190] Similar to valuation of securities, the value of a CDS is based on underlying obligations of the reference entity. In other words, the cost of a particular CDS depends on the reference entity's credit health (i.e. how likely is it that the mortgage payments are going to be made). If, however, access to information about an entity's credit health is restricted, pricing of these instruments becomes nearly impossible.[191] Pricing a CDS without any information about the reference entity's credit health would be analogous to buying a used car without knowing its service history, whether it had previously been in an accident, or even the vehicle's blue book price. In essence, you are buying blind. The opportunity exists to get a really great deal, but the opportunity also exists to get a really poor deal. You won't realize what type of deal you received, however, until you own the car for a while.[192]

One of the primary uses of CDSs over the past decade has been to hedge against credit risk of collateralized debt obligations ("CDO") – a structured asset-backed security ("ABS").[193] While a CDO can be comprised of any number of debt obligations (e.g. bonds), the most infamous CDOs have been crafted out of mortgages on residential properties.[194] These specific CDOs are known as mortgage-backed securities ("MBS").[195]

---

190. *Id.* at 1 – 2 (A CDS written on assets not owned or connected to the buyer is called a "naked CDS.").

191. *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1026 (2007) (noting that CDSs provide information to market participants when their pricing is publicly available).

192. Economists call this "asymmetric information." *See* George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 489-92 (1970).

193. *Collateralized Debt Obligations*, N.Y. TIMES, http://topics.nytimes.com/topics/reference/timestopics/subjects/c/collateralized-debt-obligations/index.html (last visited May 7, 2010).

194. *Mortgage-Backed Securities*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/m/mortgage-backed-securities/index.html (last visited May 7, 2010) ("As the mortgage market soured in 2007, the financial world came to two sickening realizations about mortgage-backed securities. They were not nearly as safe as had been expected -- partly because securitization meant that banks originating loans for a quick sale did not have to be as careful about their soundness as when they held mortgages to maturity. And both the ratings agencies that analyze securities and many of those who bought or traded them had turned a blind eye to warning signs, like an increase in foreclosures. In addition, the complexity of the securities and the arrangements made to insure them turned out to have amplified the risks, not diluted them.").

195. *See* U.S. SEC, MORTGAGE-BACKED SECURITIES, http://www.sec.gov/answers/mortgagesecurities.htm (last visited May 7, 2010).

B. Mortgage Backed Securities and the Sub-Prime Mortgage Crisis

In its simplest form, MBSs are created by pooling a large number of mortgages together into one financial instrument known as a security. In the United States, "[m]ost MBSs are issued by the Government National Mortgage Association (Ginnie Mae), a government agency, or the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac,)", both of which are government-sponsored enterprises.[196] "Some private institutions, such as brokerage firms, banks, and homebuilders, also create "private-label" mortgage securities."[197]

The first step in creating a MBS is to buy up a large number of mortgages. The banks and other lenders who originate mortgages ("originators") are generally glad to sell their pool of mortgages to the MBS issuers because the originators can use the proceeds to make more loans right away, rather than waiting on the relatively small cash flow from homeowners paying their mortgages every month. After the MBS issuers have a large enough pool of mortgages, they can slice them up into different classes – known as "tranches" – depending on various factors such as risk of default on the underlying mortgages.

An individual or organization who invests in a riskier MBS can expect a higher return on the security.[198] Of course, this also means that the investor may not receive any return on their investment if the underlying assets (i.e. the stream of monthly mortgage payments) fail to produce. Because the risk exists that a MBS will fail to pay off, investment banks began issuing CDSs so that investors in MBSs could hedge against the credit risk associated with the securities. Eventually, however, speculators who did not own the underlying MBSs began to invest in "naked" CDSs.[199]

Because the cash flows of an MBS depend on all of the underlying mortgages being paid on time, as long as homeowners can afford to continue making their monthly payments, the investors in the security can expect steady returns, and the seller of a CDS will continue to receive steady cash flows from the buyer of the CDS. If, however, the homeowners default on their mortgages, the investors will no longer receive their steady cash flows, but will – as long as they purchased a CDS – receive the predetermined settlement amount from the seller of the CDS. Speculators

196. *Id.* (alteration in original).

197. *Id.*

198. *See* FED. DEPOSIT INS. CORP., *supra* note 22. Because the risk associated with any given MBS is directly correlated to the risk of the homeowner making timely payments on the mortgage, riskier MBSs are comprised of higher rate mortgages known as "sub-prime" mortgages.

199. *See* Sarra, *supra* note 192.

who purchase naked CDSs can also expect to receive a settlement amount from the seller of the CDS.

Beginning in 2007, the number of homeowners who held adjustable rate sub-prime mortgages ("ARM") that were either delinquent or against whom foreclosure proceedings had begun, started to increase.[200] Once these credit events began, the previously predictable cash flows from the MBSs started to slow, and the CDSs that investors and speculators purchased began to vest. If an investor in an MBS failed to purchase the credit risk protection provided by a CDS, though, the potential existed for these investors to suffer immense financial losses.[201] Additionally, for those firms that sold CDSs, the realization set in that instead of receiving a steady cash inflow, they were now on the hook to settle their positions with the investors that purchased CDSs, as well as the speculators that did the same. The lack of liquidity by the sellers of CDSs led, in part, to mass panic in the United States and world financial markets and, ultimately, the bailout of many prominent financial firms and banks.

C. Lack of Regulation of Credit Default Swaps

For purposes of the Securities Act of 1933,[202] and the Securities Exchange Act of 1934[203] – both of which the SEC are responsible for enforcing – CDOs and MBSs fit within the definition of securities. CDSs, on the other hand, are OTC derivatives, and as such, are neither regulated by the SEC or the CFTC. Although the lending of sub-prime mortgages coupled with the increased default rate by homeowners led to significant financial losses when the value of the MBSs declined, the large settlement amounts on CDSs – amounts that firms never expected to, and could not, pay – caused the near collapse or complete failure of many prominent financial firms and banks including Citigroup, UBS, Bank of America, Wachovia, Washington Mutual, Lehman Brothers, Merrill Lynch, and Bear Stearns.[204] Fearing the

---

200. *See* Ben S. Bernanke, Fed. Res., The Recent Financial Turmoil and its Economic and Policy Consequence(Oct. 15, 2007) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20071015a.htm#f1).

201. *See* Michael M.Grynbaum, *Bear Stearns Profit Plunges 61% on Subprime Woes*, N.Y. TIMES, Sept. 21, 2007, http://www.nytimes.com/2007/09/21/business/20cnd-wall.html?_r=1; Jenny Anderson & Andrew Ross Sorkin, *Lehman Said to Be Looking for a Buyer as Pressure Builds*, N.Y. TIMES, Sept. 10, 2008, http://www.nytimes.com/2008/09/11/business/11lehman.html?_r=1&hp&oref=slogin.

202. 15 U.S.C. § 77a (2006).

203. 15 U.S.C. § 78a (2006).

204. *See* Markham, *supra* note 174, at 537; Colin Barr, *The Truth About Credit Default Swaps*, FORTUNE, Mar. 16, 2009, http://money.cnn.com/2009/03/16/markets/cds.bear.fortune/index.htm.

potential for another financial crisis, in 2008, the President and Congress pushed for financial reform, including the regulation of OTC derivatives.

IV. PRESIDENT'S WORKING GROUP'S REACTION TO THE FINANCIAL CRISIS

A. The Response of the President's Working Group to the Financial Crisis

On March 18, 1988, President Ronald Reagan signed an executive order creating the Working Group on Financial Markets ("PWG").[205] The PWG is also known as the "Plunge Protection Team" because it was created in response to the events surrounding the 22.61% drop in the Dow Jones Industrial Average ("DJIA") on October 19, 1987 ("Black Monday").[206] The PWG is comprised of: "(1) the Secretary of the Treasury, or his designee; (2) the Chairman of the Board of the Federal Reserve System , or his designee; (3) the Chairman of the [SEC], or his designee; and (4) the Chairman of the [CFTC], or her designee."[207] The Secretary of the Treasury serves as the Chairman of the PWG.[208]

In response to the 2008 financial crisis, the PWG issued a statement on October 6, 2008 in which it outlined its broad initiatives to stabilize the financial markets.[209] The issues the PWG intended to address included: (1) strengthening financial institutions by purchasing troubled assets, and addressing the raising of capital; (2) providing FDIC assistance to potential failing banks; (3) increasing liquidity to financial markets through the use of the Federal Reserve's purchasing and lending facilities; (4) increasing the flexibility of bank holding companies to provide financial support to their bank funds; (5) increasing the FDIC's ability to borrow from the Treasury; (6) increasing Fannie Mae and Freddie Mac's purchases of MBSs and; (7) encouraging further centralized clearing for other financial instruments to bring enhanced transparency and counterparty risk management to those markets.[210] This last initiative was, of course, in response to the lack of regulation of the OTC derivatives market.

A month after this outline of initiatives was released, the PWG expanded on its objectives for the OTC derivatives market by providing an outline of the steps it deemed necessary to establish stability in the mar-

---

205. Exec. Order No. 12631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

206. E.S. Browning, *Exorcising Ghosts of Octobers Past*, WALL ST. J., Oct. 15, 2007, http://online.wsj.com/article/SB119239926667758592.html?mod=mkts_main_news_hs_h.

207. *See* Exec. Order No. 12631, *supra* note 208 (alteration in original).

208. *Id.* (alteration in original).

209. President's Working Group on Financial Markets, U.S. Dep't Treasury (Oct. 6, 2008) (transcript of statement available at http://www.treas.gov/press/releases/hp1177.htm).

210. *Id.*

ket.[211] The PWG noted that reform was needed to improve market transparency for the previously unregulated CDS market.[212] The PWG noted that this goal could be accomplished by requiring the public reporting of prices, trading volumes and aggregate open interest of market participants, and housing this information at a central repository.[213] The PWG also recommended establishing consistent risk management standards for entities that participate in the OTC derivatives market, as well as the clearinghouses.[214] It was further suggested that legislation should be enacted to require derivatives market participants to clear all eligible contracts through a central counterparty ("CCP") and that all CDSs not cleared through a CCP were to be retained in a central contract repository.[215] Finally, the PWG observed the need for continued cooperation among both domestic and foreign regulators – including the CFTC and SEC – of the derivatives markets.[216]

B. Treasury White Paper and the CFTC/SEC Joint Meeting on Harmonization

As a sign of the new era of increased cooperation between regulators of the derivatives markets, on September 2 and 3, 2009, the CFTC and SEC held a joint meeting for the first time to help initiate harmonization of regulation of derivatives.[217] The meeting was in response to a June 17, 2009 White Paper of the Treasury Department on Financial Regulatory Reform

---

211. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, U.S. DEP'T OF TREASURY, POLICY OBJECTIVES FOR THE OVER-THE-COUNTER (OTC) MARKET (2008), http://www.treas.gov/press/releases/reports/policyobjectives.pdf.

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*; *See also* U.S. DEP'T OF TREASURY, MEMORANDUM OF UNDERSTANDING BETWEEN THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE U.S. COMMODITY FUTURES TRADING COMMISSION AND THE U.S. SECURITIES AND EXCHANGE COMMISSION REGARDING CENTRAL COUNTERPARTIES FOR CREDIT DEFAULT SWAPS (2008), *available at* http://www.treas.gov/press/releases/reports/finalmou.pdf. (A CCP for CDSs may be a state-chartered bank that is a member of the Federal Reserve; a derivatives clearing organization ("DCO") as defined in Section 1a(9) of the CEA and that is registered with the CFTC, or a clearing agency as defined by the Securities Exchange Act of 1934 over which the SEC has regulatory and supervisory responsibilities. The memorandum of understanding between the Federal Reserve, CFTC, and SEC reflects the "intent to cooperate, coordinate and share information, including by establishing regulatory liaisons, in carrying out their respective responsibilities and exercising their respective authorities with regard to Central Counterparties for credit default swaps. The Parties have a common interest in strengthening the infrastructure supporting the clearing and settlement of credit default swaps.").

216. *Supra* note 211.

217. Cmty. Futures Trading Comm'n, Joint Meeting on Harmonization of Regulation 4 (Sept. 2, 2009) (transcript available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcsecjoint_090209_transcript.pdf).

("White Paper") which outlined a plan for restoring public confidence in the integrity of the financial system.[218] Observing that "[t]he broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency," the White Paper requested that the CFTC and SEC identify "all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to . . . investor protection, market integrity, and price transparency or make[] recommendations for changes to statutes and regulations that would eliminate the differences."[219] The White Paper also proposed the creation of a new Financial Services Oversight Council ("Oversight Council") to identify emerging systemic risks and improve interagency cooperation.[220]

Additionally, the White Paper recommended creating two new agencies; (1) the Consumer Financial Protection Agency – an independent agency dedicated to consumer protection in credit, savings, and payments markets; and (2) the National Bank Supervisor - an agency with separate status within the Department of the Treasury with the responsibility for federally chartered depository institutions.[221] The Oversight Council would be chaired by the Secretary of the Treasury, and include (1) the Chairman of the Federal Reserve; (2) the Director of the National Bank Supervisor; (3) the Director of the Consumer Financial Protection Agency; (4) the Chairman of the SEC; (5) the Chairman of the CFTC; (6) the Chairman of the FDIC; and (7) the Director of the Federal Housing Finance Agency ("FHFA") – a new independent regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks created by the 2008 Housing and Economic Recovery Act ("HERA").[222]

After holding the two day meeting on harmonization in response to the Treasury Department's request, the CFTC and SEC submitted a joint report in which a series of specific recommendations were made for strengthening the two agencies' oversight and enforcement responsibilities.[223]

The joint report recommended, *inter alia*, the passage of legislation that would provide certainty with respect to current and future jurisdictional disputes between the CFTC and SEC, legislation that would authorize the CFTC to enable rules requiring certain exchanges and clearinghouses to

---

218. U.S. DEP'T OF TREASURY, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, FIN. STABILITY (2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

219. *Id.* at 49-51 (alteration in original).

220. *Id.* at 3.

221. *Id.* at 4.

222. *Id.* at 20.

223. SEC, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION, (2009), http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

comply with the CEA, legislation to empower the CFTC to require foreign boards of trade to register with the CFTC, and perhaps most important to harmonization of the two agencies, the creation of joint committees, task forces, and cross-agency training programs to facilitate the exchange of information between agency staff members.[224]

V. THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

On December 11, 2009, the House of Representatives passed the original Wall Street Reform and Consumer Protection Act ("Financial Reform Act"), but it was not until May 20, 2010 that the Senate passed the same bill in lieu of its own proposed financial reform bill.[225] After the Senate insisted on amendments being made to the Financial Reform Act, a conference committee was assembled, and on June 29, 2010, a conference report was filed.[226] On June 30, 2010, the House agreed to the conference report, with the Senate following suit on July 15, 2010.[227] On July 21, 2010, the President of the United States signed the Financial Reform Act into law.[228]

Title VI of the Financial Reform Act is titled the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010."[229] This Act prohibits a bank or a bank holding company from engaging in proprietary trading, including trading of derivatives, that is not at the behest of its clients, while also imposing capital requirements upon institutions engaging in derivatives trading.[230] Title VII of the Financial Reform Act is titled the "Wall Street Transparency and Accountability Act of 2010 ("WSTA")."[231] Subtitle A of the WSTA addresses the regulation of OTC derivatives – specifically, the previously unregulated OTC swap market.[232] Subtitle B of the WSTA addressed the regulation of the security-based swap markets.[233] The WSTA specifically authorizes regulation of most derivative transactions by the

224. *Id.* at 86 – 95.

225. Bill Summary & Status - 111th Congress (2009 - 2010) - H.R. 4173 - All Information-THOMAS (Library of Congress), http://thomas.loc.gov/cgi-bin/bdquery/D?d111:6:./temp/~bdIoYn::|/home/LegislativeData.php?n=BSS;c=111| (last visited July 28, 2010).

226. *Id.*

227. *Id.*

228. *Id.*

229. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 601, 124 Stat. 1376, 1596 (2010).

230. *Id.* §§ 616, 619.

231. *Id.* § 701.

232. *Id.* §§ 711-754.

233. *Id.* §§ 761-774.

CFTC and SEC, requires the clearing of more derivative transactions through central clearing houses, subjects swap transactions to margin requirements and swap dealers and major swap participants to capital requirements, and requires all trades to be reported.[234] Title VIII of the Financial Reform Act, known as the Payment, Clearing, and Settlement Supervision Act of 2010 grants the Federal Reserve the authority to regulate and examine payment, clearing, and settlement functions of derivatives.[235] Additionally, the Financial Reform Act adopted the recommendations of the Treasury Department[236] by establishing the Financial Stability Oversight Council in Title I of the Financial Reform Act, known as the Financial Stability Improvement Act of 2010,[237] while Title X of the Act, known as the Consumer Financial Protection Act creates the Bureau of Consumer Financial Protection.[238] The most prominent effects of these provisions on derivatives regulation will be addressed in more detail below.

A. Financial Stability Improvement Act of 2010

Title I of the Financial Reform Act establishes a Financial Services Oversight Council ("Oversight Council"), comprised of the Secretary of the Treasury to serve as Chairman, the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chairman of the SEC, the Chairman of the FDIC, the Chairman of the CFTC, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and "an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise[,]" as voting members, as well as the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a State insurance commissioner, a State banking supervisor, and a State securities commissioner, each of whom will be selected by their peers, to serve as nonvoting members.[239] This 15 person council has responsibility for "identify[ing] risks to the financial stability of the United States, promoting 'market disciple' by eliminating the expectation that the federal government will shield individuals and organizations from financial losses in the event of a financial collapse, and responding to emerging threats to the financial markets.[240] The Oversight Council is authorized to obtain financial information necessary to fulfill these responsi-

234. *Id.* §§ 701 - 74.
235. *Id.* §§ 801 – 14.
236. *See* U.S. DEP'T OF TREASURY, *supra* note 221.
237. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 101, 111.
238. *Id.* §§ 1001, 1011.
239. *Id.* § 111(b).
240. *Id.* § 112(a).

bilities.[241] Additionally, the Oversight Council may determine whether a foreign or domestic non-bank financial company should be subject to supervision by the Federal Reserve "by a vote of no fewer than 2/3 of the voting members" of the council.[242] The council shall make recommendations to the Federal Reserve concerning the establishment of prudential standards for the supervision of these non-bank financial companies.[243] Finally, the council may "issu[e] recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards."[244]

B. Consumer Financial Protection Act of 2010

Title X of the Financial Reform Act establishes the Bureau of Consumer Financial Protection ("BCFP").[245] The BCFP is an independent agency within the Federal Reserve System with responsibility for researching developments in the markets for consumer financial products and services,[246] providing information about financial products and services to traditionally underserved consumers,[247] collecting and tracking consumer complaints regarding financial products and services,[248] and rulemaking.[249] The BCFP has sole or joint jurisdictional authority over non-depository financial institutions that primarily offer personal loans secured by real estate (e.g. mortgage originators), and "loan modification or foreclosure relief services in connection with [these] loans."[250] The BCFP also has sole or joint jurisdictional authority over larger participants in the financial products and services markets,[251] as well as sole jurisdiction over insured depository institutions or credit unions with total assets exceeding $10 billion.[252] Insured depository institutions or credit unions with less than $10 billion in total assets are subject to inspections by the BCFP, but only prudential regulators[253] are granted the authority to take enforcement action against these

241. *Id.* § 112(b).
242. *Id.* § 113(a)(1).
243. *Id.* § 115(a)(1).
244. *Id.* § 120(a) (alteration in original).
245. *Id.* § 1011(a).
246. *Id.* § 1013(b)(1).
247. *Id.* § 1013(b)(2).
248. *Id.* § 1013(b)(3).
249. *Id.* § 1022(a).
250. *Id.* § 1024(a)(1)(A) (alteration in original).
251. *Id.* § 1024(a)(1)(B) (the BCFP is required to consult with the Federal Trade Commission prior to issuing a rule defining "larger participants).
252. *Id.* §1025(a)(1).
253. 7 U.S.C § 1a(39) (2010) (prudential regulators include: (1) the Federal Reserve Board, (2) the Office of the Comptroller of the Currency, (3) the Federal Deposit Insurance Corporation, (4) the Farm Credit Administration, or (5) the Federal Housing Finance Agency).

entities. "[I]ndividuals and organizations, and conduct excluded from the jurisdictional authority of the BCFP include: (1) state licensed real estate brokers, (2) manufactured and modular home retailers, (3) accountants and tax preparers, (4) attorneys, (5) persons regulated by any state insurance or securities regulators, the SEC, the CFTC, or the Farm Credit Administration, and (6) activities related to charitable contributions."[254] Nonetheless, the CFTC and SEC are to consult with the BCFP with respect to rules addressing similar type of products or services offered by persons subject to the authority of the BCFP.[255]

C. Wall Street Transparency and Accountability Act of 2010

Title VII of the Financial Reform Act allocates jurisdiction over security-based swaps with the SEC, and all other swaps with the CFTC.[256] Security-based swaps are added to the definition of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934.[257] As such, an offer or sale of a security-based swap by or on behalf of the issuer of the underlying security, its affiliate, or underwriter is considered an offer or sale of the underlying security. There is no requirement that the SEC deem an owner of a security-based swap to be the beneficial owner of the underlying security or that the security-based swap have "incidents of ownership comparable to direct ownership of the equity security."[258] Both agencies share joint regulatory jurisdiction over "mixed swaps."[259]

254. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1027 (alteration in original).

255. *Id.* § 1027(i)(2), (j)(2).

256. *Id.* § 712(b)(1)-(2).

257. *Id.* §§ 761(a), 768(a) (amending 15 U.S.C. § 78c(a)(10) (2010) and 15 U.S.C. § 77b(a)(1) (2010), respectively).

258. 15 U.S.C. 78m(o) (2010).

259. Dodd-Frank Wall Street Reform and Consumer Protection Act § 712(a)(8); 7 U.S.C. 1a(49)(D) (2010) ("The term 'security-based swap' includes any agreement, contract, or transaction that is as described in section 3(a)(68)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)(A)) and also is based on the value of 1 or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow- based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence . . . .").

1. *Clearing of Swaps and Security-Based Swaps*

The WSTA requires that all swaps and security-based swaps be cleared, unless an exemption exists.[260] The CFTC and SEC may exempt a swap or security-based swap from clearing if: (1) the swap or security-based swap is not accepted for clearing by a derivatives clearing organization ("DCO") or a clearing agency; or (2) one party to the contract is not a dealer or major swap or security-based swap participant and that party does not meet the eligibility requirement of a DCO/clearing agency.[261] Further, the CFTC and SEC are stripped of most of their exemptive authorities – which previously allowed these agencies to excuse parties from clearing requirements – except where specifically authorized, and all proposed exemptions must be cleared with the Oversight Council first.[262]

All derivatives clearing organizations are required to submit to the CFTC for prior approval of any swaps the organization seeks to accept for clearing, and the CFTC shall take final action with respect to these requests no later than 90 days after they are made.[263] The CFTC or SEC can stay the clearing requirement of a swap or security-based swap that it has approved for listing upon request of either party to the contract, or on its own, and must then determine within 90 days whether the product does or does not need to be cleared.[264] A product that the CFTC or SEC determines does not need to be cleared is nonetheless allowed to be cleared.[265] The WSTA requires both the CFTC and SEC to adopt rules requiring maintenance of records of uncleared swap and security-based swap transactions, respectively, to be made available to one another.[266]

2. *Participation in the Swap and Security-Based Swap Markets*

The WSTA makes it "unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market."[267] This requirement does not apply if, as stated above, the swap or

260. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723(a), 763(a) (amending 7 U.S.C. § 2(e)(3) and 15 U.S.C. 78a(3C)(a) , respectively).

261. *Id.*

262. *Id.* §§ 721(d), 763(a) (amending 7 U.S.C. § 6(c)(1) and 15 U.S.C. § 78a(3C)(i), respectively).

263. *Id.* § 745(b) (amending 7 U.S.C. § 7a-2(4)(C) (2010)).

264. *Id.* §§ 723(a), 763(a) (amending 7 U.S.C. § 6(c)(1) (2010) and 15 U.S.C. § 78a(3C)(i) (2010), respectively).

265. *Id.*

266. *Id.* § 712(d)(1)-(3).

267. *Id.* § 723 (amending 7 U.S.C. § 2(e) (2010)).

security-based swap is not accepted for clearing.[268] Additionally, if a party to a swap or security-based swap is a commercial user, that party may either elect to clear, or not to clear the transaction.[269]

Further, both the CFTC and SEC can prohibit a foreign entity from participating in any swap activity in the United States if it is determined that such an activity would undermine the stability of the United States financial system.[270] The WSTA requires the CFTC and SEC to consult and coordinate with foreign regulators on standards and regulation related to derivatives.[271]

The WSTA defines a swap or securities-based swap dealer as a person who (1) holds itself out as a dealer in swaps or securities-based swaps; (2) makes a market in swaps or securities-based swaps; (3) regularly engages in the purchase and sale of swaps or securities-based swaps in the ordinary course of business; or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps or securities-based swaps.[272] A person may be designated a dealer for one type or class of swap or securities based swap but not any other swap or securities based swap.[273]

A major swap or securities-based swap participant ("major participant") is any person who is not a dealer, and (1) maintains a substantial position in swaps or securities-based swaps for any of the major categories of instruments excluding (i) positions held for hedging or mitigating commercial risk; and (ii) positions maintained by an employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; or (2) whose outstanding swaps or securities-based swaps create substantial counterparty exposure that could have serious adverse effects on the United States financial markets; or (3) is a (i) financial entity, other than an entity predominantly engaged in providing financing for the purchase of an affiliate's merchandise or manufactured goods, that is highly leveraged relative to the amount of capital it holds; and (ii) maintains a substantial position in outstanding swaps or securities-based swaps in any major category as determined by the CFTC or SEC.[274]

---

268. *See supra* note 264.

269. Dodd-Frank Wall Street Reform and Consumer Protection Act § 723 (amending 7 U.S.C. § 2(h)(7)(B) (2010)).

270. *Id.* § 715.

271. *Id.* § 752.

272. *Id.* §§ 721; 761 (amending 7 U.S.C. § 1a(49) and 15 U.S.C. 78c(a)(71) (2010), respectively).

273. *Id.*

274. *Id.* §§ 721, 761 (amending 7 U.S.C. § 1a(33) and 15 U.S.C. 78c(a)(66) (2010), respectively).

Additionally, the WSTA prohibits federal government bailouts of swap entities. The Act provides that "no Federal assistance may be provided to any swaps entity with respect to any…activity of the swaps entity."[275] "'Federal assistance' means the use of any funds, including advances from [the] Federal Reserve [or] . . . Federal Deposit Insurance Corporation insurance . . . ."[276] This provision effectively requires most derivatives activities to be conducted outside of banks and bank holding companies if these entities hope to receive federal assistance because "[c]urrently, five of the largest commercial banks account for 97 percent of the commercial bank notional swap activity."[277]

3. *Capital and Margin Requirements*

Under the new provisions, the CFTC and the SEC are authorized to set capital and margin requirements for swap and securities-based swap dealers and major participants.[278] Additionally, the agencies are authorized the set position limits on swaps or securities-based swaps that "perform or affect a significant price discovery function."[279] The CFTC or SEC may exempt, conditionally or unconditionally, any person or class of persons, any swap or securities-based swap, or any transaction or class of transactions from any requirement that either commission establishes with respect to position limits.[280]

D. Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010

Title VI of the Financial Reform Act prohibits a bank or a bank holding company from engaging in proprietary trading of derivatives, as well as other financial instruments, not at the behest of its clients, while also banning trading where potential conflicts of interest exist.[281] The Act also requires regulators to impose minimum capital amounts that are "countercyclical, so that the amount of capital required to be maintained by a company

275. *Id.* § 716(a) (alteration in original).
276. *Id.* § 716(b)(1) (alteration in original).
277. Blanche Lincoln, Chairman, Senate Agric., Nutrition, and Forestry Comm., S. 3217 – The Restoring American Financial Stability Act of 2010 (May 5, 2010) (statement available at http://lincoln.senate.gov/newsroom/2010-5-5-1.cfm).
278. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 736, 763.
279. *Id.* §§ 737, 763.
280. *Id.*
281. *Id.* § 619 (amending 12 U.S.C. § 1841(13)(a)(1)) ("[u]nless otherwise provided in this section, a banking entity shall not (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.").

increases in times of economic expansion and decreases in times of economic contraction."[282] Finally, the Act allows state chartered banks to engage in derivatives trading only if the law with respect to lending limits of the State in which the insured State bank is chartered takes into consideration credit exposure to derivatives transactions.[283]

E. Payment, Clearing, and Settlement Supervision Act of 2010

Title VIII of the Financial Reform Act imposes the responsibility on the Oversight Council to designate, by a vote of no fewer than 2/3 of the voting members of the council, what "financial market utilities or payment, clearing, or settlement activities that the Council determines are, or are likely to become, systemically important."[284] All designated utilities or activities are subject to the authority of the Federal Reserve risk management standards, with certain standards being prescribed in consultation with the CFTC and SEC.[285] The objective of the Federal Reserve's risk management standards are to (1) promote robust risk management; (2) promote safety and soundness; (3) reduce systemic risks; and (4) support the stability of the broader financial system.[286] These provisions, therefore, provide the Federal Reserve with the authority to impose standards on participants in the derivatives markets if the Oversight Council designates these markets as systemically important. Given the role that the OTC derivatives market played in the 2008 financial crisis, it is nearly certain that the Oversight Council will designate the derivatives markets as systemically important.

VI. EVALUATION OF THE FINANCIAL REFORM ACT'S PROVISIONS ADDRESSING DERIVATIVES REGULATION

The provisions of the Financial Reform Act that have the largest impact on derivatives regulation create additional regulatory entities; presume clearing and settlement of most derivatives through a CCP; impose capital and margin requirements on derivatives markets participants; and ban banks from most derivatives trading.

---

282. *Id.* § 616(a)(2).
283. *Id.* § 611.
284. *Id.* § 804(a)(1).
285. *Id.* § 805(a).
286. *Id.* § 805(b).

A. Creation of Additional Financial Regulatory Entities

The purpose of the BCFP is to protect consumers against poor lending practices of banks and mortgage originators. As discussed above, the sub-prime mortgage crisis – which was a direct result of poor lending practices – led, in part, to the 2008 financial collapse. Derivatives do not live in a vacuum, rather, they are priced based on the value of the underlying asset, which, in the case of CDSs, were MBSs. Therefore, in order to achieve greater control over CDSs and other similar instruments, there must be sufficient regulation of the underlying assets. Unfortunately, the Financial Reform Act fails to provide the BCFP with sufficient regulatory power. The Act does not provide the BCFP with any enforcement authority over banks with assets totaling less than $10 billion. This means that as of December 31, 2009, only the largest 514 commercial banks out of the 6369 total in the United States (or 8.07%) would be subject to the BCFP's enforcement authority.[287] Although the BCFP is given rulemaking authority over all financial institutions, the Financial Reform Act requires the BCFP to confer with other financial regulators before writing these rules and gives the Oversight Council the right to veto and proposed rules with a 2/3 vote. It appears that the BCFP – an agency created, in part, to increase oversight over the mortgage lending practices that helped cause the 2008 financial collapse – may be nothing more than another layer in the ever expanding United States financial regulation industry.

Creating new agencies and councils for financial regulation clearly does not help resolve the jurisdictional battles between financial regulators in recent decades. As one commentator recently put it:

> the United States now operates under a 'functional' regulatory system. Under this system, different regulators are appointed to regulate particular financial services, even if those services are offered by the same firm. This has resulted in much overlap and regulatory conflict, and created a system that failed to anticipate the subprime crisis. That the functional regulatory system failed should not be a surprise. It is a haphazard system of regulation that is not the result of a design or reasoned blueprint.[288]

Rather than merely adding on to the existing regulatory framework, a better plan would be to create a single financial regulator with broad – but clear – jurisdictional authority.

---

287. FED. DEPOSIT INS. CORP., Statistics on Depository Institutions Report (2009), http://www2.fdic.gov/sdi/main.asp.

288. *See* Markham, *supra* note 174.

B. Costs and Benefits of Derivatives Clearance and Settlement Through CCPs

The WSTA creates the presumption that derivatives will be cleared through a CCP. This is in clear contrast to the primary OTC derivatives practice of bilateral netting, whereby parties offset the gains or losses of one contract with those of another contract.[289] OTC derivative participants have voluntarily utilized CCPs for clearing of transactions well before the WSTA.[290] Nonetheless, this practice has not caught on industry wide, which would tend to indicate that the costs of CCP clearing outweigh the benefits. By requiring CCP clearing, the WSTA essentially concentrates the credit exposure previously spread across the participants in the $600 trillion OTC derivatives market into a small number of central parties. Doing so only benefits the market if CCPs can provide less risk exposure than the participants themselves. In other words, the CCPs must be able to match up market participants that want to manage their risk exposure better than the participants would be able to do by themselves. While organized financial markets have clearly made it more cost effective for participants to buy and sell financial instruments,[291] it is unclear whether CCPs will be able to do the same for all derivative instruments.

Parties enter into OTC derivative transactions based on their individual needs. Unlike items that can be purchased on exchanges (e.g. securities, futures, and physical commodities), OTC derivatives do not all have the same terms, meaning that parties must spend time negotiating them. If parties are required to go through a CCP, they may incur additional costs – either in the form of time or money. A CCP does not exactly match parties up, but rather, substitutes itself as the buyer to every seller and the seller to every buyer. This process helps ensure that any given transaction will be settled. Nonetheless, the CCP must find two parties between which

---

289. For instance, imagine that two parties – A and B – enter into two OTC swap transactions. The first transaction is a fixed-for-floating interest rate swap on the underlying bond instruments. The second transaction is a CDS on a MBS. If Party A sustains a net loss of $5000 on the first transaction, but earns a $6000 net gain on the second transaction, the parties would merely offset these amounts, and Party B would pay Party A $1000.

290. *See, e.g.*, BANK FOR INT'L SETTLEMENTS, OTC DERIVATIVES: SETTLEMENT PROCEDURES AND COUNTERPARTY RISK MANAGEMENT (1998), http://www.bis.org/publ/cpss27.pdf?noframes=1.

291. Simply imagine if a party owned a share of XYZ, Corp. – a publicly traded security – but did not have a marketplace to sell it. One might envision this individual taking out an advertisement in the newspaper to try and sell the share. The creation of major securities exchanges have allowed buyers and sellers to come together in a true market to achieve the best prices for these instruments. Without these markets, an individual in New York could end up paying a vastly different price than an individual in California for the same security, simply because all the information about the supply and demand of the security is not available to all market participants.

it can stand. If parties provide the CCP with their desired terms, the CCP – through a central database – could automatically match up the counterparties. If, however, the CCP is unable to find two "matching" parties, it would then required the parties to submit amended contract terms in hopes of making a match. In this case, the parties incur additional time (and cost) by going through the same negotiation process they otherwise could have "off exchange." While the CCP helps play "matchmaker," it does not necessarily save the parties any time or money.

On the other hand, the benefits of requiring central clearing and settlement include the preservation of a central repository for required filings of participants, and more efficient default resolution. Requiring parties to go through a CCP allows the regulators and other derivatives parties access to additional information about these participants. The additional information tends to make pricing more efficient and regulation less problematic – assuming the regulators are provided with the resources necessary to do so.[292] Additionally, if a party's lack of liquidity makes it unable to settle a particular contract despite meeting the margin requirements, the CCP would be able to go through a bilateral netting procedure to offset a party's losses with any gains sustained in another contract. This is in contrast to the possibility of a party walking away from an OTC derivative contract if it cannot pay, leaving the other party to seek a judicial remedy which may cost more in attorneys' fees than it is worth.

As it stands right now, many participants in the financial products markets are exempted from registration, disclosure, and clearing requirements. This clearly leaves room for potential future collapses in the financial markets. Instead, Congress should draft clear legislation that requires all financial products to be entered into on an exchange. Although there are costs associated with bringing all of these transactions onto an exchange, as the 2008 financial crisis made clear, there is the very real potential for losing parties of OTC derivatives to suffer significant financial losses, which in turn, affect the United States and international economies.

---

292. The Financial Reform Act is not the only bill that will impact financial regulation. The provisions of this Act will have little to no effect unless the House and Senate Appropriation Committees provide the regulators with the resources necessary to enforce them. For example, CFTC Chairman Gary Gensler asserted that the new provisions of the Financial Reform Act "will require $45 million and 119 additional staff in FY 2011 and more in subsequent years." *See* Gary Gensler, Chairman, Commodity Futures Trading Comm., Oral Testimony Before the Senate Committee on Appropriations (Apr. 28, 2010) (transcript available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-40.pdf).

D. Costs and Benefits of Capital and Margin Requirements

By imposing capital and margin requirements, the WSTA requires that all parties wanting to enter into a derivative transaction demonstrate that they are liquid enough to meet their settlement obligations if so required. As observed above, many of the firms that sold CDSs on MBSs did not anticipate the sub-prime mortgage crisis that led to mass mortgage defaults. As a result of the enormous settlement amounts triggered by the mortgage defaults, many firms were unable to compensate the MBS investors or CDS speculators. Both sides of the CDS transactions, therefore, sustained significant losses.

The margin requirements seek to ensure that the parties put up enough capital prior to entering into contracts to cover a significant portion of the eventual settlement amounts, while the capital requirements seek to ensure that if an unanticipated credit event occurs requiring a significant transfer of capital between parties, the party who owes the net settlement amount would be able to compensate the other party. In other words, these requirements help guarantee that the losing party can pay up. Margin and capital requirements already exist for participants in commodity futures and options products,[293] as well as security futures[294] and options products.[295]

As mentioned earlier, the transactions costs associated with swaps generally preclude speculators from entering into contracts. Increased margin and capital costs (as well as the costs associated with clearing and settlement through a CCP) will potentially drive more speculators out of the market. Speculators, however, serve a valuable purpose to the futures and options markets and, to a less extent, the swaps market, by providing liquidity. Many participants in the OTC derivatives market do not contract for hedging purposes but rather, speculate about the movement in the value of an underlying asset. For a party seeking to hedge its risk, these speculators serve as a counterparty with which the hedging party can contract. If speculators are forced out of the derivatives market due to increased transactions costs, hedgers may be unable to hedge against the risk of shifting asset values. Thus, CCPs and federal regulators must be careful not to impose overly burdensome capital and margin requirements so as to "dry up" the liquid market.

---

293. *See, e.g.*, CME GROUP, PERFORMANCE BOND/MARGIN RATES, http://www.cmegroup.com/wrappedpages/clearing/pbrates/performancebond.html (last visited June 2, 2010).

294. *See, e.g.*, 17 C.F.R. § 41.45 (2010).

295. *See, e.g.*, CHICAGO BOARD OPTIONS EXCHANGE, CHICAGO BOARD OPTIONS EXCHANGE MARGIN MANUAL (2000), http://www.cboe.com/tradtool/marginmanual2000.pdf.

Nonetheless, the intent behind imposing capital and margin requirements on swap participants is clear. Capital and margin requirements will almost certainly shrink the current $600 trillion OTC derivatives market by limiting parties to only those that can afford to participate. A smaller, more liquid market means a smaller potential financial collapse in the event of an economic emergency.

D. Banning Banks from Most Derivatives Trading

Just as the imposition of capital and margin requirements have the potential to shrink the current derivatives market, so too does the ban of banks from most derivatives trading. As stated above, Senator Blanche Lincoln estimated that "five of the largest commercial banks account for 97 percent of the commercial bank notional swap activity."[296] The purpose of this provision is to get "banks back to performing the duties they were meant to perform – taking deposits and making loans for mortgages, small businesses and commercial enterprise; and . . . [separate] out the activities that put these institutions in peril."[297] This provision will, however, allow banks to use swaps for hedging purposes because hedging against interest rate and default risk are considered banking activities.

It is possible that banks who previously participated in swap activities will merely spin off these departments into independent affiliates. These affiliates, however, would not be eligible for federal assistance, meaning that discipline would be required of their swap trading activities. By imposing discipline on these swap market participants, the WSTA helps ensure that risky trading will cease to exist in the future.

VII. CONCLUSION

With respect to derivative transactions, the Financial Reform Act seeks to bring the OTC derivatives market out of the dark and put them on the same level playing field as most other major financial markets. The Financial Reform Act, by brining swaps and securities-based swaps under the regulatory authority of the CFTC and SEC, respectively, takes a giant leap forward in the world of derivatives regulation. It is unclear, though, whether this legislation will be enough to fix the problems caused by the deregulatory CFMA or whether a complete overhaul of the United States financial system is required. By creating a presumption that all swap transactions will be cleared through CCPs, requiring recordkeeping of all cleared and uncleared swap transactions, and imposing significant margin and capital requirements on swap and securities-based swap dealers and

296. Lincoln, *supra* note 280.
297. *Id.*

major participants, more information about the financial health of parties to derivative transactions will be known. Increased transparency, though, does not mean that the derived benefits will necessarily outweigh the costs associated with mandatory clearing. Additionally, the Financial Reform Act creates new financial regulatory and enforcement agencies – including BCFP – which may very well lead to sluggish rulemaking and enforcement and future turf battles similar to those fought between the CFTC and SEC over the past 35 years. Only time will tell if the Financial Reform Act can mitigate the potential damage of future financial collapses.