

New Paradigms and Familiar Tools in the New Derivatives Regulation

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ABSTRACT

Title VII of the Dodd-Frank Wall Street Reform Act is a study in contrasts. On the one hand, Dodd-Frank transforms the U.S. approach to derivatives regulation from a laissez-faire, almost no oversight paradigm into one featuring heavy supervision, supervision focused on the safety and soundness of derivatives markets participants. The commitments to capital and margin requirements, clearinghouses and international cooperation reflect a European vision of financial intermediaries as heavily regulated utilities, rather than the more traditionally American willingness to tolerate the speculative aspects of capital markets. On the other hand, the tools that Dodd-Frank employs to pursue safety and soundness draw inspiration from those that private market actors have employed for centuries. Adopting a more heavily regulated banking paradigm for the formerly (mostly) unregulated derivatives markets, but using market based tools to advance the goals of safety and soundness, might seem like two regulatory reforms working at cross-purposes. However, it may be a sign that real changes in the United States' vision of well-functioning derivatives markets—providing options for sophisticated investors, but not ones laden with hidden systemic risk—are being pursued incrementally, even after comprehensive regulatory reform.

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INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection (“Dodd-Frank”) Act’s¹ derivatives title, Title VII, is a study in contrasts.² It both transforms federal regulation of the derivatives markets in a fundamentally statist way, and yet, in doing so, also harkens back to a pre-regulatory environment.³ In this Article’s view, the best way to think about the Act is to understand it as transformative in its regulatory goals, but traditional in the tools it uses to achieve these goals. Indeed, the signature regulatory tool of Title VII, the clearinghouse, has been used in American financial markets since the nineteenth century.⁴

Dodd-Frank transforms the approach to derivatives regulation from a *laissez-faire* paradigm to a bank regulatory paradigm focused on safety and soundness.⁵ The commitments to capital requirements clearinghouses and international cooperation reflects a more European vision of financial intermediaries as heavily regulated utilities providing services to the economy, rather than the more American willingness to tolerate the aspects of capital markets that are effective at facilitating price discovery through speculation.⁶ This shift also reflects the importation of “know your customer” and margin requirements into formerly unregulated markets—not unheard of in commodities and futures trading regulation, of course, but still very different from the old hands-off approach.⁷

But even as Dodd-Frank reflects a more regulatory paradigm, the tools it uses to pursue safety and soundness in the derivatives markets are similar to those that have been employed by private market actors to assess and mitigate risk for centuries.⁸ Viewed in this light, Dodd-Frank’s derivatives regime looks both traditional and transformative.

¹ Dodd-Frank Wall Street Reform and Consumer Protection (“Dodd-Frank”) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

² See *id.* tit. VII, 124 Stat. at 1641.

³ See *infra* Part I.A.

⁴ See *infra* Part I.A.

⁵ See *infra* Part II.

⁶ See *infra* Part II.

⁷ See *infra* notes 103–05 and accompanying text.

⁸ See *infra* Parts II.B–D.

The real difference between the clearinghouses under the new derivatives rules and those created in earlier eras is the formalization of a market-wide clearing requirement, along with the additional standardization of information necessary to make these traditional, and reasonably robust, market solutions more effective.⁹

Adopting a more heavily regulated banking paradigm for the formerly mostly unregulated derivatives markets, but using market based tools to do much of the safety and soundness work, might seem like two regulatory reforms working at cross-purposes. It appears, however, to be a sign that real changes in the United States' vision of well-functioning derivatives markets—providing options for sophisticated investors, while reducing hidden systemic risk—are being pursued incrementally, even after comprehensive regulatory reform.

Change can only be examined with reference to the past. This Article first looks at the federal regulatory scheme prior to the 2008 financial crisis, one of self-regulation and sporadic federal oversight, before taking each new development in the future of derivatives regulation in turn in Part II.

I. THE PAST

Federal regulation of derivatives has proceeded in fits and starts after a post-Depression flurry of regulatory activity. Others have traced in detail the various lobbying efforts and interagency turf wars that have occurred through the years as derivatives proliferated—including, most significantly, financial derivatives.¹⁰ This Article will not repeat those efforts. Instead, it begins with the story of early attempts at self-regulation, which first emerged in the private markets, and then progresses through the various developments in the common law and federal regulatory structure that wrestled with the contours of the basic framework as established by the marketplace.

A. Self-Regulation

The early history of the U.S. derivatives markets is one of self-regulation. Central counterparty clearing, a core feature of Dodd-Frank's effort to address safety and soundness,¹¹ grew out of private

⁹ See *infra* Part II.D.

¹⁰ See, e.g., Colleen M. Baker, *Regulating the Invisible: The Case of Over-the-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1311 (2010).

¹¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. VII, 124 Stat. 1376, 1641 (2010) (providing for clearing requirements for swaps and derivatives markets).

agreements among market participants in the nineteenth century. In the United States, clearinghouses emerged in conjunction with the formation of exchanges.¹² For example, the Chicago Board of Trade (“CBOT”), recognizing the importance of designing incentives for its members to obey the rules of the exchange, barred any member that defaulted on its obligations from participating in the exchange.¹³ Of course, because the loss of trading privileges alone might not provide a significant deterrent for a member teetering on the edge of solvency, so, beginning in 1873, the CBOT required any member whose solvency was in question to submit its financial accounts to the Board for inspection.¹⁴ Members refusing to do so could be dropped from the exchange.¹⁵ The CBOT also adopted margin requirements and established strict time limits for posting margin deposits.¹⁶

All of these requirements, designed and enforced by the exchange, were geared to monitor and control financial risks. By 1883, the CBOT had developed a nascent clearinghouse structure designed to reduce transaction costs by calculating the obligations of exchange members to post margin deposits and to settle contracts.¹⁷ At this early stage, the clearinghouse would not settle the trades of a defaulting member or offset losses to other members if those losses exceeded the amount of posted margin.¹⁸

The private exchange structure complimented what was then the common law’s open hostility to certain forms of derivatives trading. On the one hand, hedging agreements, in which at least one of the parties actually owned or expected to own the underlying asset, were thought to provide a useful market tool for spreading risk.¹⁹ On the other hand, speculative contracts or “difference contracts,” in which neither party owned or expected to own the underlying assets, were void and unenforceable and viewed essentially as a form of gambling, with many of the same attendant social ills.²⁰ Speculation was not illegal per se, but the costs of entering into such contracts were increased

¹² See Randall S. Kroszner, *Can the Financial Markets Privately Regulate Risk?: The Development of Derivatives Clearinghouses and Recent Over-the-Counter Innovations*, 31 J. MONEY CREDIT & BANKING 596, 599–601 (1999).

¹³ See *id.*

¹⁴ *Id.* at 601.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ See *id.*

¹⁹ Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 11–12 (2011).

²⁰ *Id.*

because they could not be enforced in court.²¹ For speculators, the solution was to move their trading activities to private venues—commodity exchanges—with their own mechanisms for enforcing difference contracts when courts would not.²² Speculators wishing to trade on such an exchange were required to trade through an exchange member, who would guarantee performance.²³ As the CBOT example makes clear, the exchanges imposed a variety of requirements on their members, including collateral posting, capital requirements, and standardized contract terms, in order to ensure that members could fulfill their guarantees.²⁴

The basic exchange trading structure was endorsed in the United States Supreme Court's 1905 opinion, *Board of Trade of Chicago v. Christie Grain & Stock Co.*,²⁵ which effectively held that futures contracts entered into on the commodity exchanges were legally enforceable because performance by “set off”—that is, the purchase of a second, offsetting futures contract for the delivery of the same quantity of goods on the same delivery date—had the practical effect of actual delivery.²⁶ In his opinion for the Court, Justice Holmes presaged the laissez-faire view that came to characterize the resistance to derivatives regulation since the earliest days of the marketplace:

[I]n a modern market contracts are not confined to sales for immediate delivery. People will endeavor to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn. But legislatures and courts generally have recognized that the natural evolutions of a complex society are to be touched only with a very cautious hand, and that such coarse attempts at a remedy for the waste incident to every social function as a simple prohibition and laws to stop its being are harmful and vain.²⁷

21 Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 715–16 (1999).

22 *See id.* at 777.

23 *Id.* at 778, 786.

24 *See* Kroszner, *supra* note 12, at 598–601.

25 *Bd. of Trade of Chi. v. Christie Grain & Stock Co.*, 198 U.S. 236 (1905).

26 *Id.* at 250 (“A set-off is in legal effect a delivery.”).

27 *Id.* at 247–48.

With the legal road cleared for private exchange trading, clearinghouse structures became more robust. In the years that followed Justice Holmes's decision, the CBOT created a formal clearinghouse, the Board of Trade Clearing Company, to serve as the counterparty to all exchange transactions.²⁸ Exchange members were required to purchase shares in the clearinghouse and post margin deposits directly to the clearinghouse.²⁹ And, unlike its earlier variants, the clearinghouse would assume responsibility for settling the trades of defaulting members, initially through their posted margin deposits, but in the event such deposits were insufficient, through charges to the clearinghouse's own capital.³⁰ Under clearinghouse rules, members could be required to purchase additional shares in the unlikely event that the default depleted the clearinghouse's capital.³¹ By holding each exchange member responsible for the obligations of every other member, the clearinghouse structure provided important incentives for exchange members to adopt and support effective risk controls.

Not all exchange-clearinghouse arrangements evolved in the same way. While some exchanges were integrated with their clearinghouses, like the CBOT, other exchanges had their trades cleared through unaffiliated clearinghouses.³² The critical point, however, is that many of the safety and soundness features of Dodd-Frank's take on derivatives regulation—including, for example, margin requirements, financial record transparency, and central counterparty clearing—emerged initially as private market mechanisms for identifying and regulating financial risks.³³ These private monitoring mechanisms were successful. Indeed, prior to the financial crisis, clearinghouse failures were rare.³⁴ Of course, the financial crisis exposed the potential dangers of a wholly self-regulated derivatives marketplace, including the failure of private monitoring structures to keep pace with the

²⁸ Kroszner, *supra* note 12, at 602.

²⁹ *Id.*

³⁰ *Id.* at 602–03.

³¹ *Id.* at 602.

³² See COMM. ON PAYMENT & SETTLEMENT SYS., BANK FOR INT'L SETTLEMENTS, MARKET STRUCTURE DEVELOPMENTS IN THE CLEARING INDUSTRY: IMPLICATIONS FOR FINANCIAL STABILITY 10–11, 26 (2010).

³³ See Kroszner, *supra* note 12, at 600–01; see also *infra* Part II.

³⁴ In the past 40 years, three prominent clearinghouses have failed: (1) the Caisse de Liquidation in Paris in 1974 when sugar-futures prices fell sharply; (2) the Kuala Lumpur Commodities Clearing House when palm-oil futures crashed in 1983; and (3) the Hong Kong Futures Exchange in 1987 following the global market crash. See Paul Tucker, Deputy Governor Fin. Stability, Bank of Eng., Clearing Houses as System Risk Managers, Speech at the DTCC-CSFI Post Trade Fellowship Launch 4 (June 1, 2011).

growth and complexity of the market. But, as this Article will show, Dodd-Frank's ultimate regulatory response, in some ways, appears geared simply toward shoring up the smooth functioning of private market mechanisms.

B. Federal Derivatives Regulation

Passed in the flurry of market reforms that followed the Great Depression, the legislation that eventually became the Commodity Exchange Act of 1936 ("CEA")³⁵ was intended to discourage speculation on commodity exchanges.³⁶ The CEA, as amended, required all futures contracts to be traded on a regulated exchange with clearing mechanisms.³⁷ The exchange trading requirement was intended to provide greater transparency in trading behavior and price formation.³⁸ More importantly, however, the clearing requirements ensured both that financial intermediaries stood between futures contract counterparties and that commitments underlying those contracts were well-capitalized.³⁹ Because the clearing facility bore the ultimate risk of any contract failure, the clearinghouses had strong incentives to monitor the capital of market participants and the accuracy of market prices on which margin requirements were based.⁴⁰ Much like the federal securities statutes passed a few years before,⁴¹ the CEA also imposed registration requirements on certain market participants, including futures commission merchants ("FCM"), and required the segregation of FCM funds from customer funds.⁴²

This federal regulatory framework changed somewhat in 1974 with the passage of the Commodity Futures Trading Commission Act ("CFTC Act").⁴³ As commentators have noted, the CFTC Act re-

³⁵ Commodity Exchange Act ("CEA") of 1936, ch. 545, 49 Stat. 1491 (codified at 7 U.S.C. §§ 1-17 (2006)).

³⁶ *See id.* (preamble states its purpose as: "to limit or abolish short selling [and] to curb manipulation" in commodity futures exchanges).

³⁷ *See id.* sec. 5, § 4a, 49 Stat. at 1492 (codified at 7 U.S.C. § 6a (2006)).

³⁸ *See id.* sec. 5, § 4c(C), 49 Stat. at 1494 (codified at 7 U.S.C. § 6c(C) (2006)) (making it unlawful to complete trades that would cause a price to be recorded that is not the bona fide price).

³⁹ *Id.* sec. 5, § 4a, 49 Stat. at 1494 (codified at 7 U.S.C. § 6a (2006)).

⁴⁰ *See supra* note 30 and accompanying text.

⁴¹ *See, e.g.*, Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l (2006) (requiring registration of securities).

⁴² CEA, sec. 5, § 4d(1), 49 Stat. at 1494 (codified at 7 U.S.C. § 6d(1) (2006)) (requiring futures commission merchants to register with the Secretary of Agriculture); *id.* sec. 5, § 4d(2) (requiring separation of customer funds and FCM funds).

⁴³ Commodity Futures Trading Commission ("CFTC") Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389.

sponded to public criticism that federal regulation of commodity futures markets was, at the time, inadequate to meet the challenges of rapidly increasing futures trading volume and the accompanying potential for unethical practices and price manipulation.⁴⁴ The CFTC Act created a new independent agency, the Commodity Futures Trading Commission (“CFTC”), with exclusive jurisdiction over commodity futures and options.⁴⁵ The CFTC Act also expanded the CEA’s definition of “commodity” to include, in addition to specific agricultural commodities, “all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.”⁴⁶ This amendment allowed exchange trading of futures contracts on virtually any underlying asset, including financial instruments.⁴⁷ It also effectively banned off-exchange trading of those instruments.⁴⁸ In 1989, however, the CFTC announced that it would exempt swaps—agreements between two parties to exchange a series of cash flows—from the CEA exchange trading requirement.⁴⁹

The regulatory sea change came with the Commodity Futures Modernization Act of 2000 (“CFMA”),⁵⁰ which provided the regulatory (or rather, deregulatory) backdrop for the derivatives markets that led up to the financial crisis. Conflict began with the CFTC’s May 1998 Concept Release, which proposed significant changes in the regulation and oversight of the OTC derivatives market, including clearing of OTC derivatives, registration and reporting requirements for dealers and intermediaries, capital requirements, and various business conduct restrictions.⁵¹ In November 1999, the President’s Working Group on Financial Markets issued a report that recommended that the CFTC should not have regulatory jurisdiction over the OTC

⁴⁴ See Graham Purcell & Abelardo Lopez Valdez, *The Commodity Futures Trading Commission Act of 1974: Regulatory Legislation for Commodity Futures Trading in a Market-Oriented Economy*, 21 S.D. L. REV. 555, 556–57 (1976).

⁴⁵ CFTC Act sec. 101(a)(3), § 2(a)(2), 88 Stat. at 1389 (codified at 7 U.S.C. § 4a (2006)) (establishing the CFTC); *id.* sec. 201(b), § 2(a), 88 Stat. at 1395 (codified at 7 U.S.C. § 2(a)(1)(A) (2006)) (granting the CFTC exclusive jurisdiction over commodity futures).

⁴⁶ *Id.* sec. 201(b), § 2(a), 88 Stat. at 1395.

⁴⁷ See Purcell & Valdez, *supra* note 44, at 575.

⁴⁸ See 7 U.S.C. § 6 (2006); Purcell & Valdez, *supra* note 44, at 589 n.230.

⁴⁹ Stout, *supra* note 19, at 19.

⁵⁰ Commodity Futures Modernization Act (“CFMA”) of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-365, (codified at 7 U.S.C. §§ 1, 27 (2006)).

⁵¹ See Concept Release, Commodity Futures Trading Comm’n, Over-the-Counter-Derivatives (May 6, 1998), available at <http://www.cftc.gov/opa/press98/opamntn.htm>.

derivatives markets.⁵² Congress responded with the CFMA, effectively eliminating federal regulation of off-exchange derivatives trading, including capital adequacy requirements, reporting and disclosure requirements, regulation of financial intermediaries, clearing requirements, and prohibitions on fraud, manipulation, and speculation.⁵³ With the stroke of a pen, Congress excluded from CFTC oversight most off-exchange financial derivatives transactions by “eligible contract participants,” a list broadly defined to include banks, investment banks, pension plans, and corporations that met certain asset thresholds.⁵⁴ The CFMA also excluded from regulation off-exchange swap transactions between eligible contract participants.⁵⁵

The markets for OTC derivatives exploded in the wake of the CFMA: the total notional value of OTC derivatives grew from approximately \$88 trillion in 1999, just prior to the CFMA, to more than \$670 trillion on the eve of the financial crisis in 2008.⁵⁶

This private ordering was not entirely free from regulatory input. In the pre-Dodd-Frank days of non-regulation, private monitoring mechanisms in the derivatives markets were somewhat supplemented by “guidances” issued by prudential regulators concerning certain bank and financial institutions trading in, and making use of, deriva-

52 See PRESIDENT’S WORKING GRP. ON FIN. MKTS., OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 1, 15–16 (1999), available at <http://www.treasury.gov/resource-center/fin-mkts/documents/otcact.pdf>.

53 See Commodity Futures Modernization Act sec. 103, § 2(d), 114 Stat. at 2763A-377; *id.* sec. 105, § 2(f), 114 Stat. at 2763A-378.

54 See *id.* sec. 101, § 1a, 114 Stat. at 2763A-366–376; *id.* sec. 105(b), § 2(g), 114 Stat. at 2763A-379.

55 See *id.* sec. 105(b), § 2(g), 114 Stat. at 2763A-379.

56 Stout, *supra* note 19, at 23 nn.92–93. Amendments to the Bankruptcy Code also arguably enhanced the growth of the market into this regulatory free space created by the CFMA. As a general matter, the Bankruptcy Code’s automatic stay provision bars creditors from terminating contracts or seizing assets from a firm in bankruptcy. 11 U.S.C. § 362 (2006). Virtually since its inception, the Bankruptcy Code has offered special exemptions from the automatic stay for certain commodities and forwards contracts. Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 646 (2005). In 2005, however, Congress expanded the exemption to include “swap agreements,” which effectively brought all derivatives contracts, including credit derivatives, within the scope of the exemption. See *id.* at 650–52. As a practical matter, that means derivatives counterparties could come to the front of the creditor line to collect from failing debtors. Some have argued that the super-priority status given to derivatives and repo counterparties under the 2005 Bankruptcy Code amendments helped increase systemic risk and reduce incentives for private monitoring that fueled the Crisis. See Mark J. Roe, *The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 542 (2011). Others critiqued the 2005 amendments at the time as potentially contributing to systemic risk. See Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 103–05 (2005).

tives.⁵⁷ For example, the Board of Governors of the Federal Reserve System issued a collection of supervisory letters beginning in the 1990s concerning the risks associated with credit derivatives, their increased usage by member banks, and the ways in which internal risk management and capital adequacy programs should take such trading activities into account.⁵⁸ The Office of the Comptroller of the Currency issued similar guidance during the 1990s, urging banks within its purview to adopt risk assessment and internal control systems to effectively assess and manage counterparty risk in financial derivatives.⁵⁹ Therefore, although many derivatives transactions effectively remained outside of formal regulatory frameworks for much of the modern run up to Dodd-Frank, prudential regulators have recognized the potential safety and soundness implications of derivatives trading for market participants for decades.⁶⁰

⁵⁷ See *infra* text accompanying notes 59–60.

⁵⁸ See, e.g., Supervisory Letter from Bd. of Governors of Fed. Reserve Sys. on Risk Mgmt. & Capital Adequacy of Exposures Arising from Secondary Mkt. Credit Activities, SR 97-21 (SUP), 3–4 (July 11, 1997), available at <http://www.federalreserve.gov/boarddocs/srletters/1997/sr9721.htm>; Supervisory Letter from Bd. of Governors of Fed. Reserve Sys. on Sound Credit Risk Mgmt. & the Use of Internal Credit Risk Ratings at Large Banking Orgs., SR 98-25 (SUP), 2 (Sept. 21, 1998), available at <http://www.federalreserve.gov/boarddocs/srletters/1998/sr9825.htm> (“[E]xaminers should be cognizant that an internal risk identification and monitoring system should be consistent with the nature, size and complexity of the banking organization’s activities. In this context, those institutions with significant involvement in relevant secondary market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing the risks associated with these activities.”); Supervisory Letter from Bd. of Governors of Fed. Reserve Sys. on Supervisory Guidance for Credit Derivatives, SR 96-17 (GEN), 7 (Aug. 12, 1996), available at <http://www.federalreserve.gov/boarddocs/srletters/1996/sr9617.htm> (“For purposes of risk-based capital, credit derivatives generally are to be treated as off-balance sheet direct credit substitutes. The notional amount of the contract should be converted at 100 percent to determine the credit equivalent amount to be included in risk weighted assets of the guarantor.”).

⁵⁹ See Banking Issuance, Comptroller of the Currency Adm’r of Nat’l Banks, Risk Mgmt. of Fin. Derivatives, BC-277, 5 (Oct. 27, 1993), available at <http://www.occ.gov/static/news-issuances/bulletins/pre-1994/banking-circulars/bc-1993-277.pdf>.

⁶⁰ This is not to overstate the point. This prudential guidance on derivatives was principally focused on credit derivatives—a narrower segment of the overall OTC derivative market that raises particular prudential concerns. Credit derivatives are a form of derivative that is based on the credit risk—that is, the risk to a firm that a borrower or obligor will default on its payment obligations to the firm—of another firm or financial instrument. Erik F. Gerding, *Credit Derivatives, Leverage, and Financial Regulation’s Missing Macroeconomic Dimension*, 8 BERKELEY BUS. L.J., no. 2, 2011, at 29, 30. As a form of credit protection, credit derivatives effectively allow lenders to offload existing credit risk and extend new credit, thereby facilitating credit expansion and asset price increases. See *id.* at 31–32. This macroeconomic dimension of credit derivatives, and not the safety and soundness implications of the OTC market in general, arguably encouraged these early statements of prudential guidance. See *id.*, stating:

The cocktail of credit derivatives and leverage also can have significant macroeconomic effects. By allowing financial institutions—those institutions that

II. THE FUTURE

Warren Buffet termed derivatives “financial weapons of mass destruction,” but, of course, not all of them are potentially destructive, or even interesting.⁶¹ Credit default swaps (“CDS”), for example, may have brought down the insurance titan and Fortune 10 company AIG, but it is worth noting that, according to the Basel Committee, CDS contracts only comprise less than five percent of global derivatives notional exposure.⁶² The number and notional amount of CDS contracts were hypertrophying—but so was the larger derivatives market. That market includes prosaic interest rate swaps, as well as the largest category of derivatives, foreign exchange derivatives, and exotics that reference weather, politics, commodities, stocks, and a potentially endless variety of sources of business uncertainty.⁶³

This market has grown since 1995 by approximately twenty-four percent per year.⁶⁴ Its customers remain largely wholesale—the major participants are banks, investment firms, insurance companies, and corporations.⁶⁵ The notional value of global derivatives trading is more than four times larger than the combined global equity and bond markets.⁶⁶ By 2008, only sixteen percent of the notional amount of this market was trading on exchanges.⁶⁷

The changing and rapidly growing background of derivatives was part of what led to rumblings seeking regulation in the years before the financial crisis, but it was the crisis itself that generated the mo-

borrow to lend—to increase leverage, credit derivatives can operate to increase the overall amount of liquidity in financial markets. This increase in liquidity can be thought of as increasing the effective supply of money in the market, which can have a number of significant economic consequences. By increasing leverage and liquidity, credit derivatives can fuel rises in asset prices and even asset price bubbles. Rising asset prices can then mask mistakes in the pricing of credit derivatives and in assessments of the risk of overall leverage in the financial system.

⁶¹ Andrew R. Sorkin, *Derivatives, as Accused by Buffett*, N.Y. TIMES DEALBOOK (Mar. 14, 2011, 9:17 PM), <http://dealbook.nytimes.com/2011/03/14/derivatives-as-accused-by-buffett/>.

⁶² *Semiannual OTC Derivatives Statistics at End-December 2011*, BANK FOR INT’L SETTLEMENTS (Sept. 2012), http://www.bis.org/publ/qtrpdf/r_qs1209.pdf. The derivatives markets are overwhelmingly markets for interest rate derivatives—swaps account for sixty-seven percent of the global derivatives notional exposures, as of 2011, while forwards and options add another sixteen percent. *Id.*

⁶³ *See id.*

⁶⁴ DEUTSCHE BÖRSE GRP., *THE GLOBAL DERIVATIVES MARKET: AN INTRODUCTION 11* (2008), available at [http://deutsche-boerse.com/mr/binary/0A4A6E3F8ED836BDC1257457002D5669/\\$File/2008-04%20DB_WP%20GlobalDerivativesMarket_e.pdf?OpenElement](http://deutsche-boerse.com/mr/binary/0A4A6E3F8ED836BDC1257457002D5669/$File/2008-04%20DB_WP%20GlobalDerivativesMarket_e.pdf?OpenElement).

⁶⁵ *Id.* at 4.

⁶⁶ *Id.* at 11.

⁶⁷ *Id.* at 10, 12.

mentum for the reforms prompted by Dodd-Frank.⁶⁸ On the one hand, Dodd-Frank's reforms are dramatic, as they took an essentially unregulated trading market and subjected it not just to trading market regulation, but also to the sort of safety and soundness regulation that previously covered banks—that is, the banks that everyday consumers use and that are insured by the federal government, not investment banks to which access is limited to the sorts of putatively sophisticated players that make up the bulk of the participants in the derivatives marketplace.⁶⁹ On the other hand, there is a lot of market-based precedent for the sorts of derivatives regulation selected by the Act. And finally, as discussed in the conclusion of this Article, there is a great deal of international inspiration and impetus behind the work being done here.⁷⁰

Broadly, Title VII of the Act overhauls the pre-crisis approach by requiring reporting of swap transactions,⁷¹ including public reports of swap prices and volumes, clearing of many swaps to remove counterparty credit risk and hopefully reduce systemic risk,⁷² oversight of the important participants in the derivatives market,⁷³ and prudential regulation to deal with systemic risk posed by the markets.⁷⁴

The reporting and clearing requirements reflect more intensive regulation, but are entirely consistent with the capital markets regulation paradigm; though their purpose, as will be shown, is directed more towards ensuring the safety and soundness of the financial system, rather than towards enabling capital formation. The oversight and prudential regulation functions created by Dodd-Frank, however, are a different matter. Oversight, it seems, imposes several requirements: capital adequacy rules for swap dealers,⁷⁵ ethical business con-

⁶⁸ See generally Manuel Roig-Franzia, *Credit Crisis Cassandra*, WASH. POST, May 26, 2009, at C1. Former CFTC chair Brooksley Born famously suggested the possibility of regulation of the markets, only to be forbidden from doing so by a congressional moratorium on derivatives regulation. For a discussion of Born's efforts in this regard by one derivatives lawyer, see *Brooksley Born*, ECONOMICS OF CONTEMPT (May 25, 2009, 11:29 PM), <http://economicsofcontempt.blogspot.com/2009/05/brooksley-born.html>.

⁶⁹ See Dodd-Frank Wall Street Reform and Consumer Protection ("Dodd-Frank") Act, Pub. L. No. 111-203, sec. 764, § 15F, 124 Stat. 1376, 1784-85 (2010) (codified at 15 U.S.C. § 780-8 (2006)).

⁷⁰ See *infra* Part II.F.

⁷¹ Dodd-Frank Act sec. 729, § 4r, 124 Stat. at 1701 (codified at 7 U.S.C. § 6r (Supp. IV 2011)).

⁷² See *id.* § 723, 124 Stat. at 1675 (codified at 7 U.S.C. § 2).

⁷³ *Id.* § 113, 124 Stat. at 1398 (codified at 12 U.S.C. § 5323).

⁷⁴ *Id.* § 716, 124 Stat. at 1648 (codified at 15 U.S.C. § 8305).

⁷⁵ *Id.* §§ 115, 731, 124 Stat. at 1403, 1703 (codified at 12 U.S.C. § 5325, 7 U.S.C. § 6s); see

duct requirements for most large participants,⁷⁶ the Glass-Steagal-like separation of derivatives desks from federally insured banks,⁷⁷ and the Volcker Rule's spinning off of proprietary trading in derivatives.⁷⁸ These mandates illustrate the paradigm shift being made in the statute. Prudential regulation reflects the financialist paradigm of Title VII. The following discussion provides an overview of the requirements of Title VII, premised on its purpose to regulate derivatives markets like banks.

A. *The New Regulators*

Title VII splits oversight of the derivatives market between the CFTC and SEC, although the division is rather uneven—the CFTC's purview reaches the broader swath of current and future products.⁷⁹

The SEC has been given responsibility over “security-based swaps,”⁸⁰ which include instruments that reference nine or fewer securities.⁸¹ All other swaps are subject to CFTC oversight,⁸² including security-based swaps that reference ten or more securities.⁸³ “Mixed swaps,” or swaps that reference both commodities and securities,⁸⁴ are to be regulated by both commissions jointly.⁸⁵

However, Dodd-Frank does not authorize the agencies to regulate every derivative product—it is, instead, an effort to supervise the most complicated products created and consumed by the most sophisticated investors. Forward-based contracts (these are the simple puts and options much favored by day traders) are accordingly exempted, as is the approximately ten percent of the global market covered by foreign exchange swaps, which, if regulated, would raise some sovereign immunity concerns.⁸⁶

also Professor Henry T. C. Hu, *Keynote Address: The Sec, Dodd-Frank, and Modern Capital Markets*, 7 N.Y.U. J. L. & Bus. 427, 430 (2011) (“The complexity of developing rules that properly balance systemic risk concerns while accommodating worthwhile derivatives transactions can be seen through the lens of a single task that Dodd-Frank assigns to the SEC: developing capital adequacy standards for security-based swap dealers that are not banks.”).

⁷⁶ Dodd-Frank Act § 932, 124 Stat. at 1872 (codified at 15 U.S.C. § 780-7).

⁷⁷ *Id.* § 716, 124 Stat. at 1648 (codified at 15 U.S.C. § 8305).

⁷⁸ *Id.* sec. 619, § 13, 124 Stat. at 1620 (codified at 12 U.S.C. § 1851).

⁷⁹ *See id.* § 712(a)(1), 124 Stat. at 1641 (codified at 15 U.S.C. § 8302).

⁸⁰ *Id.* § 712(a)(2), 124 Stat. at 1641 (codified at 15 U.S.C. § 8302).

⁸¹ Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(a)(55)(B), (68)(A) (2006).

⁸² Dodd-Frank Act § 712(a)(1), 124 Stat. at 1641 (codified at 15 U.S.C. § 8302).

⁸³ *See* 15 U.S.C. §§ 78c(a)(55)(B), (68)(A).

⁸⁴ 15 U.S.C. § 78c(a), (68)(D).

⁸⁵ Dodd-Frank Act § 712(a)(8), 124 Stat. at 1642 (codified at 15 U.S.C. § 8302 (Supp. IV 2011)).

⁸⁶ *See id.* sec. 721(a)(21), § 1a(47) (codified at 7 U.S.C. § 1a(47)(B), (E) (Supp. IV 2011)).

Even with these carve outs, it is a remarkable expansion of the government's regulatory jurisdiction. Dodd-Frank reverses the ban on derivatives regulation in the 2000 CFMA entirely.⁸⁷ It awards that new regulatory authority to the classic capital markets regulators—the SEC and the CFTC.⁸⁸ But these agencies are essentially being asked to regulate the derivatives markets for safety and soundness.⁸⁹ This is especially clear in their supervision of market makers and the clearinghouses that sit between them.

B. Oversight

The regulation portion of Title VII covers “swap dealers” and “major swap participants.”⁹⁰ Swap dealers include the liquidity providers in the derivatives market, including market makers and those who hold themselves out as dealers.⁹¹ The term covers institutions like JPMorgan Chase, Bank of America, Citibank, and Goldman Sachs,⁹² all of which have been designated as systemically important financial institutions (“SIFIs”) by the Financial Stability Oversight Council (“FSOC”), and which together account for the vast majority of swaps trades in the United States.⁹³

These could be covered by Title VII, but were carved out of the statute's reach in a rulemaking by the Treasury Department, which was given authority by Congress to analyze the question. See CFTC Interpretative Statement, Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options, 50 Fed. Reg. 39,656 (Sept. 30, 1985).

⁸⁷ See, e.g., Dodd-Frank Act § 734(a), 124 Stat. at 1718 (repealing sections 5a and 5d of the CEA).

⁸⁸ *Id.* § 712(a), 124 Stat. at 1641 (codified at 15 U.S.C. § 8302 (Supp. IV 2011)).

⁸⁹ *Id.* sec. 731, § 4s(e)(3)(A), 124 Stat. at 1705 (codified at 7 U.S.C. § 6s(e)(3)(A)(i) (Supp. IV 2011)).

⁹⁰ See *id.* sec. 731, § 4s (codified at 7 U.S.C. § 6s (Supp. IV 2011)). There are similar definitions for “security-based swaps dealers” and “major securities-based swaps participants,” which are regulated by the SEC, presumably in a similar way. See *id.*; see also *id.* § 761, 124 Stat. at 1754 (codified at 15 U.S.C. § 78c(a) (Supp. IV 2011)). For simplicity's sake, this Article will conflate the analysis of the swaps and security-based swaps regulation.

⁹¹ See *id.* sec. 761(a)(6), § 3(a)(71)(A), 124 Stat. at 1758 (codified at 15 U.S.C. § 78c(a)(71)(A) (Supp. IV 2011)).

⁹² See Silla Brush, *U.S. Regulators Set Vote on Which Companies Are Swap Dealers*, BLOOMBERGBUSINESSWEEK (Apr. 17, 2012), <http://www.businessweek.com/news/2012-04-17/u-dot-s-dot-regulators-set-vote-on-which-companies-are-swaps-dealers>.

⁹³ Jamila Trindle & Andrew Ackerman, *Swap-Dealer Bar Set at \$8 Billion*, WALL ST. J., Apr. 19, 2012, at C3. In addition to the specific entities that have been designated as SIFIs, FSOC has advanced a framework for assessing the systemic importance of nonbank financial institutions, based on the application of various quantitative and qualitative metrics. See Dodd-Frank Act § 804, 124 Stat. at 1807 (codified at 12 U.S.C. § 5463 (Supp. IV 2011)). These metrics include notional derivatives exposure as a key factor in determining systemic importance. See *id.* Specifically, nonbank financial companies will advance past the initial screening stage if they have at least \$50 billion in assets and one or more of: (1) \$30 billion or more in gross notional

“Major swap participant” is a more capacious term, and one that has already worried some nonfinancial institutions, such as energy firms, that are heavy players in the commodities markets.⁹⁴ The term covers entities that engage in “systemically important” derivatives activity—a term familiar to students of financial regulation, where the goal is to supervise financial intermediaries to avoid systemic risk.⁹⁵ Dodd-Frank covers those derivatives market participants that hold “substantial” positions and create “substantial counterparty exposure.”⁹⁶

Swap dealers and major swap participants must meet margin and capital requirements as well as conform to standards of business conduct.⁹⁷ They also must divest or ring fence their derivatives businesses—a development in Title VII reminiscent of old financial regulatory policies separating retail from investment banking.⁹⁸

credit default swaps for which the company is the reference entity; (2) \$3.5 billion in derivative exposures (after accounting for cash collateral and netting agreements); (3) \$20 billion in total debt outstanding; (4) a minimum 15:1 assets to equity leverage; or (5) short-term debt equal to 10% of total consolidated assets. See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,643 (Apr. 11, 2012).

⁹⁴ Silla Brush, *U.S. Regulators Set Vote on Which Companies Are Swap Dealers*, BLOOMBERG BUSINESSWEEK (Apr. 17, 2012), <http://www.businessweek.com/news/2012-04-17/u-dot-s-dot-regulators-set-vote-on-which-companies-are-swaps-dealers>. Like Enron before its collapse, some of these firms earn their profits from the provision of energy and energy trading desks. Jonathan D. Glater, *Enron's Collapse: The Company; UBS Wins the Bidding for Enron's Trading Unit*, N.Y. TIMES (Jan. 12, 2002), <http://www.nytimes.com/2002/01/12/business/enron-s-collapse-the-company-ubs-wins-the-bidding-for-enron-s-trading-unit.html>.

⁹⁵ Dodd-Frank Act sec. 721(a)(1), § 1a(33), 124 Stat. at 1663 (codified at 7 U.S.C. § 1a(33) (Supp. IV 2011)).

⁹⁶ *Id.* §§ 721, 741, 124 Stat. at 1658, 1729 (codified at 7 U.S.C. §§ 1a, 6b-1).

⁹⁷ *Id.* sec. 731, § 4s(e), (h), 124 Stat. at 1703 (codified at 7 U.S.C. § 6s(e), (h)).

⁹⁸ See *id.* § 165(d)(5)(B), 124 Stat. at 1427 (codified at 12 U.S.C. § 5365). Steven Schwarcz has defined ring-fencing, in the context of utility company regulation (although it works the same way in banking) as follows:

The term ring-fencing is not always clearly defined. By “ring-fencing,” I mean protection of [the utility subsidiary] and its assets from harm caused by the [utility subsidiary’s] affiliates. A primary goal of ring-fencing is protecting the [utility subsidiary] from harm caused by a possible bankruptcy of one or more of its affiliates. This is achieved by making it unlikely that an affiliate’s bankruptcy will involuntarily force the [utility subsidiary] into bankruptcy or cause a substantive consolidation of the affiliate and the [utility subsidiary] or cause the [utility subsidiary] to voluntarily file for bankruptcy. Another goal of ring-fencing is protecting the [utility subsidiary’s] assets from being raided by an affiliate. This can be achieved by imposing dividend restrictions on the [utility subsidiary] and by restricting non-arm’s length transactions that are unfair to the [utility subsidiary].

Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 WIS. L. REV. 815, 840 (2012) (alterations in the original).

Business conduct standards are not entirely new—they were first authorized in the securities markets by legislation in 1964.⁹⁹ Their Dodd-Frank variant, however, polices abusive conduct and adopts minimum relational standards to which the important players in the derivatives markets must adhere.¹⁰⁰

The CFTC has defined the business conduct standards to require major market participants to know their counterparties, keep records of their trades, and, perhaps most importantly, refrain from fraudulent acts or devices—language similar to that covered by the insider trading rules for the stock and bond markets.¹⁰¹ In particular, section 753 of the Act gives the commissions the authority to engage in “manipulative or deceptive device or contrivance” oversight, extending, essentially, Rule 10b5’s antifraud regime to the derivatives market.¹⁰²

The business conduct standards also require the appointment of compliance officers, conflict of interest rules, and the adoption of risk management procedures and trading monitoring.¹⁰³ Swap dealers must treat their counterparties with respect—that is, they may be held to representations on which those counterparties could reasonably rely, a basic tenet of contract law’s estoppel function, but one of previously more suspect applicability in the rough and tumble world of derivatives traders—and must communicate with them in a fair and balanced manner.¹⁰⁴ The commissions have suggested that there will

⁹⁹ For an overview of the history of business conduct standards, see generally Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069 (2005).

¹⁰⁰ For a detailed discussion of the business conduct standards required by Title VII, see Chelsea J. Bacher, *Regulating the Swaps Market After the Dodd-Frank Act: In an Economic Crisis, Is Regulation Always the Answer?*, 5 CHARLESTON L. REV. 545, 571–72 (2011).

¹⁰¹ It has followed section 753 in doing so. See *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties*, 77 Fed. Reg. 9734, 9823 (Feb. 17, 2012).

¹⁰² Section 753(a) of the Act provides that

[i]t shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate

Dodd-Frank Act sec. 753(a), § 6(c)(1), 124 Stat. at 1750 (codified at U.S.C. § 9(c)(1) (Supp. IV 2011)); see also 17 C.F.R. § 240.10b-5 (2012).

¹⁰³ Dodd-Frank Act sec. 731, § 4s(j)-(k), 124 Stat. at 1710–11 (codified at 7 U.S.C. § 6s(j)-(k)(Supp. IV 2011)); Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules, 77 Fed. Reg. 20,128 (Apr. 3, 2012) (to be codified at 17 C.F.R. Pts. 1, 3, 23).

¹⁰⁴ Dodd-Frank Act sec. 731, § 4s(h)(3), 124 Stat. at 1707 (codified at 7 U.S.C. § 6s(h)(3) (Supp. IV 2011)).

be “know your customer” requirements for swap dealers and major swap participants.¹⁰⁵

Swap dealers and major swap participants must also meet margin requirements. That is, they must post some collateral to the satisfaction of the clearinghouse to cover the credit risk to their counterparties.¹⁰⁶ Margin requirements are staples of capital markets regulation, and indeed capital markets participation, though they were previously set by contract and accordingly were capable of wide variation.

Section 731 of the Act requires dealers and major participants to meet minimum capital requirements as set forth by the commissions, which, in the case of the CFTC, are meant to meet the constraints of the Basel II capital adequacy accord.¹⁰⁷ It is these capital requirements that, more than anything else, reflect the new supervisory gestalt of Title VII. Since the failure of AIG, caused by the failure of its derivatives-trading financial products unit, the need to expand the pool of institutions subject to capital adequacy regulation—to require these institutions to have a buffer of assets available to respond to severe market reverses—has been one of the goals of financial regulatory reform.¹⁰⁸ The Basel II requirements for these players mean that each of them will, in essence, be treated as a bank, and be subjected to banking-style regulation of the resources they have on hand.¹⁰⁹

Finally, the Volcker Rule in Dodd-Frank prevents important derivatives traders from diversifying into areas susceptible to financial markets panic or protected by federal deposit insurance.¹¹⁰ This rule,

¹⁰⁵ See Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6715 (Feb. 8, 2011).

¹⁰⁶ CFTC Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732, 23,733 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23).

¹⁰⁷ Dodd-Frank Act sec. 731, § 4s, 124 Stat. at 1703 (codified at 7 U.S.C. § 6s (Supp. IV 2011)); see Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (proposed May 12, 2011) (to be codified at 17 C.F.R. pts. 1, 23, 140).

¹⁰⁸ See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-195, FINANCIAL REGULATORY REFORM: REGULATORS HAVE FACED CHALLENGES FINALIZING KEY REFORMS AND UNADDRESSED AREAS POSE POTENTIAL RISKS 36 (2013).

¹⁰⁹ *Basel II: Revised International Capital Framework*, BANK FOR INT'L SETTLEMENTS, <http://www.bis.org/publ/bcbsca.htm> (last visited Sept. 17, 2012) (“The efforts of the Basel Committee on Banking Supervision to revise the standards governing the capital adequacy of internationally active banks achieved a critical milestone in the publication of an agreed text in June 2004.”).

¹¹⁰ Dodd-Frank Act sec. 619, § 13, 124 Stat. at 1620 (codified at 12 U.S.C. § 1851 (Supp. IV 2011)) (amending the Bank Holding Company Act of 1956); see also Joint Press Release, Bd. of Governors of the Fed. Reserve Sys., FDIC, Office of the Comptroller of the Currency, Agencies Clarify Effective Date for Section 716 of the Dodd-Frank Act (Mar. 30, 2012), available at

a successor to the Glass-Steagal staple of American banking regulation,¹¹¹ offers insight into the vision that regulators, and Congress, have for the derivatives markets. The rule suggests that, to the extent that the oversight is meant for trading, it does not want that trading to destabilize systemically important institutions, and so it is attempting to severely restrict their ability to participate in the markets, at least on their own behalf.

The Volcker Rule is not the only way that participation in the derivatives markets is limited. Section 716 of the Act, the so-called “push-out rule,” prohibits “Federal assistance” to swaps dealers or major swaps participants that are not insured by the FDIC.¹¹² The push-out rule requires financial intermediaries to put their swaps units into separately capitalized subsidiaries of bank holding companies and out of the banks themselves¹¹³—the idea, once again, is that if the swap dealer branch of the financial intermediary fails, it can be “resolved” (which is the term used in banking for bankruptcy)¹¹⁴ without threatening the assets of the other subsidiaries of the bank holding company, including, most importantly, the commercial bank covered by FDIC insurance.

C. *Registration and Reporting*

Information provision is often the first step in the development of substantive regulation.¹¹⁵ But in the case of derivatives regulation, the information provision required does not amount to the proverbial camel’s nose under the tent. Instead, the advent of reporting on derivatives activity has come along with the imposition of other requirements. As was the case with broker dealers and investment advisers after 1933, information regulation begins with registration: swap dealers and major swap participants must register with the CFTC or the

www.federalreserve.gov/newsevents/press/bcreg/20120330a.htm (referring to section 716 as the “Swaps Pushout provision”).

111 PETER WALLISON, SHADOW FIN. REG. COMM., STATEMENT NO. 334, GLASS-STEAGALL AND THE VOLCKER RULE (2012), http://www.aei.org/files/2012/12/10/-statement-no-334-glass-steagall-and-the-volcker-rule_121705399814.pdf.

112 Dodd-Frank Act § 716, 124 Stat. at 1648 (codified at 15 U.S.C. § 8305 (Supp. IV 2011)).

113 *Id.*

114 *See, e.g.*, David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 157 (2010).

115 The 1933 Securities Act’s registration requirements, given all of the more intrusive securities regulation that followed it, illustrate this point, as does the hedge fund industry’s initial opposition to rules that would have required them to register with the SEC. *See, e.g.*, Securities Act of 1933 § 6, 15 U.S.C. § 77f (2006); *Goldstein v. SEC*, 451 F.3d 873, 877 (D.C. Cir. 2006).

SEC.¹¹⁶ Moreover, these entities must record and report on many of their trades, making the derivatives market more transparent.¹¹⁷ The large players in the derivatives markets are meant to offer real-time reporting of price and volume data, in addition to special notifications about large trades.

The rest of the information disclosure requirements are ministerial in nature—sections 733 and 728 of Dodd-Frank, for example, require the data on swaps and security-based swaps to be kept in an “execution facility,” an entity that will be spelled out through rulemaking but which is designed to facilitate trading through market making.¹¹⁸

D. Clearinghouses

As previously discussed, clearinghouses sit between the usual counterparties in derivatives transactions, and in doing so are meant to reduce risk in the derivatives markets.¹¹⁹ They split each transaction in two so that, rather than dealing with a counterparty about whom a derivatives trader may know little, the trader can, in essence, trade with that counterparty by trading with the clearinghouse, which will in turn trade with the counterparty.

The reason for inserting the clearinghouse as an intermediary in a trade that two participants in the derivatives market could otherwise execute on their own is a desire to provide a bit of clarity to an otherwise opaque transaction. Central clearinghouses can be backed by a fund so that the trade can still be completed if one of the parties goes bust, and margin requirements could be set by the clearinghouse to reduce this risk of default.¹²⁰ The way they ordinarily guarantee that trades will clear, however, is by netting transactions so that all the orders to buy and sell essentially balance each other out.¹²¹ The final

¹¹⁶ Dodd-Frank Act sec. 731, § 4s(a), (c), 124 Stat. at 1703–04 (codified at 7 U.S.C. § 6s(a), (c) (Supp. IV 2011)).

¹¹⁷ See *id.* sec. 729, § 4r, 124 Stat. at 1701 (codified at 7 U.S.C. § 6r (Supp. IV 2011)).

¹¹⁸ *Id.* secs. 728, 733, §§ 21, 5h, 124 Stat. at 1697, 1712 (codified at 7 U.S.C. §§ 24a, 7b-3 (Supp. IV 2011)); see *Derivatives Transaction Execution Facility—DTEF*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/d/dtef.asp#axzz21n8dq6W> (last visited Sept. 11, 2012).

¹¹⁹ See *supra* Parts I.A–B.

¹²⁰ See *supra* Part I.A.

¹²¹ See Francesca Carapella & David C. Mills, *Information Insensitive Securities: The Benefits of Central Counterparties* 23 (Apr. 23, 2012) (unpublished manuscript). The authors describe multilateral netting as

arithmetically achieved by summing each participant's bilateral net positions with the other participants, to arrive at a multilateral net position. The central counterparty is legally substituted as the buyer to every seller, and the seller to

advantage of the clearinghouse is that it increases transparency for regulators and the public by making information on market activity and exposures more available.¹²²

At least, that is the goal of Title VII.¹²³ Clearinghouses themselves can be sources of instability, yet the whole point of Dodd-Frank is to make these institutions the intermediary for a broad array of derivatives trades, leading some critics to suggest that the clearinghouse model concentrates risk rather than mediating it.¹²⁴ For this reason, it is perhaps unsurprising that section 804 provides the FSOC with the authority to designate financial market utilities—and by serving as the venue for standardized derivatives transactions, clearinghouses would count as such—as systemically important.¹²⁵ As the FSOC has observed, the clearinghouses' interconnectedness concentrates a significant amount of risk in the market so that the payment and settlement processes are highly interdependent: “Problems . . . at one system could spill over to other systems or financial institutions in the form of liquidity and credit disruptions.”¹²⁶

Moreover, as central participants in the derivatives markets, the clearinghouses themselves can be quite valuable. Additionally, central counterparties, if run for a profit, they face the same sort of risk reward incentives as those encountered by any derivatives market participant. As one commentator has observed, the clearinghouses that already exist for derivatives transactions survived the financial crisis through exercising the sort of superior crisis management that is un-

every buyer so that the multilateral net position represents the bilateral net position between each participant and the central counterparty.

Id.; but see Darrell Duffie & Haoxian Zhu, *Does a Central Counterparty Reduce Counterparty Risk*, 1 REV. ASSET PRIC. STUD. 74 (2011) (suggesting that central clearing counterparties may reduce netting efficiency and thereby increase exposure to counterparty default).

¹²² See, e.g., *supra* text accompanying notes 13–16, 24 (describing CBOT requirements for exchange members which increased CBOT's knowledge of members' financial stability and trading activities).

¹²³ See Dodd-Frank Act sec. 729, § 4r(c), 124 Stat. at 1702 (codified at 7 U.S.C. § 6r(c) (Supp. IV 2011)).

¹²⁴ See John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* 52 (Ctr. for L. & Econ. Studies, Colum. Univ. Sch. of L., Working Paper No. 380, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015 (derivatives clearinghouses “concentrate risk and so need to devise ways to avoid default”).

¹²⁵ See Dodd-Frank Act § 804(a)(1), 124 Stat. at 1807 (codified at 12 U.S.C. § 5463 (Supp. IV 2011)).

¹²⁶ Authority to Designate Financial Market Utilities as Systemically Important, 75 Fed. Reg. 79,982 (proposed Dec. 21, 2010) (to be codified at 12 C.F.R. pt. 13).

likely to be duplicated for any of the next financial catastrophes—a troubling prospect.¹²⁷

Congress was aware of the concern that clearinghouses might not survive another financial crisis, it seems, and has therefore set forth a variety of provisions meant to regulate clearinghouses, such as capital adequacy requirements.¹²⁸ The prospect that a different central counterparty might handle certain risks differently always gives one pause. This concern inspired business conduct rules regulating clearinghouses themselves, as well as potential participants in the clearinghouses.¹²⁹ Sections 723 and 764 of the Act require swaps to be cleared if the commissions deem it necessary, meaning that the commissions will review swaps on an ongoing basis to determine whether clearance should be required.¹³⁰ Moreover, the commissions have the power to mandate position limits if they determine such limits are necessary to mitigate the burden on interstate commerce imposed by excessive speculation.¹³¹

Clearinghouse rules, to be sure, do not apply to everybody. Most swap dealers and participants are meant to participate on exchanges, but Dodd-Frank provides that “eligible contract participants” can engage in private off-exchange transactions, far from either the reach or the risk of clearinghouses themselves.¹³² End users, or businesses using derivatives to engage in hedging, are also exempt from the clearinghouse mandates; however, these end users need to notify the commissions on their claim of exemption.¹³³ The rest of those who would deal on derivatives are supposed to act through clearing organizations.¹³⁴

127 See Julia Lees Allen, *Derivatives Clearinghouses and Systemic Risk: A Bankruptcy and Dodd-Frank Analysis*, 64 STAN. L. REV. 1079, 1082–83 (2012); see also Roe, *supra* note 56, at 586–87 (arguing that clearinghouses will likely themselves become systemically significant and risky); David Zaring, *Will a Clearinghouse for Derivatives Work?*, THE CONGLOMERATE (Feb. 28, 2012), <http://www.theconglomerate.org/2012/02/will-a-clearinghouse-for-derivatives-work.html> (discussing the Roe thesis).

128 Dodd-Frank Act sec. 731, § 4s(e), 124 Stat. at 1704–05 (codified at 7 U.S.C. § 6s(e) (Supp. IV 2011)).

129 See *id.* § 723, 124 Stat. at 1675 (codified at 7 U.S.C. § 2); *id.* sec. 764, § 15F, 124 Stat. at 1784–85 (codified at 15 U.S.C. § 78o-8 (Supp. IV 2011)).

130 *Id.* § 723, 124 Stat. at 1675 (codified at 7 U.S.C. § 2); *id.* sec. 764, § 15F, 124 Stat. at 1784–85 (codified at 15 U.S.C. § 78o-8).

131 See *id.* sec. 737(a), § 4a(a), 124 Stat. at 1722 (codified at 7 U.S.C. § 6a(a)).

132 *Id.* sec. 723(a)(2), § 2(e), 124 Stat. at 1675 (codified at 7 U.S.C. § 2(e)).

133 See *id.* sec. 723(a)(3), § 2(h)(7)(A), 124 Stat. at 1679 (codified at 7 U.S.C. § 2(h)(7)(A)).

134 *Id.* sec. 723(a)(3), § 2(h)(1)(A), 124 Stat. at 1675–76 (codified at 7 U.S.C. § 2(h)(1)(A)).

E. Prudential Regulation

Finally, Dodd-Frank provides a more explicit role for prudential regulators in assessing the use of derivatives by covered entities from a safety and soundness perspective. For example, section 171 directs federal banking agencies to promulgate capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies. In so doing, this section addresses the risks that the activities of such institutions pose, not only to the institution itself, but also to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity.¹³⁵ In connection with such rulemaking, the banking agencies are directed to specifically address the risks arising from significant derivatives activities.¹³⁶ The computation of capital requirements for bank holding companies and nonbank financial institutions supervised by the Federal Reserve Board must take into account off-balance sheet activities, including interest rate swaps, credit swaps, and futures and commodities contracts.¹³⁷

Likewise, Dodd-Frank amends the Federal Deposit Insurance Act to prohibit any state chartered bank from engaging in derivatives transactions unless the lending limit laws of the state in which the bank is chartered expressly take into account exposure to credit derivatives.¹³⁸ Insured depository institutions are, of course, also subject to the Volker Rule's ban on proprietary trading in derivatives.¹³⁹ Collectively these requirements, and any regulations promulgated by prudential regulators implementing these requirements, expressly address derivatives transactions as a critical component of safety and soundness for financial institutions engaged in such activities.

Dodd-Frank also envisions derivatives use as germane to determinations of systemic risk, as assessed by the macroprudential regulator—the multi-agency FSOC.¹⁴⁰ Tellingly, the first eight financial institutions designated by FSOC as “systemically important” were all, in one form or another, clearinghouses engaged in the clearing of derivatives transactions.¹⁴¹ And, as noted above, Dodd-Frank provides

135 *Id.* § 171(b)(7)(A), 124 Stat. at 1438 (codified at 12 U.S.C. § 5371(b)(7)(A)).

136 *Id.* § 171(b)(7)(B), 124 Stat. at 1438 (codified at 12 U.S.C. § 5371(b)(7)(B)).

137 *Id.* § 165(k), 124 Stat. at 1431 (codified at 12 U.S.C. § 5365(k)).

138 *Id.* sec. 611(a), § 18(y), 124 Stat. at 1612 (codified at 12 U.S.C. § 1828(y)).

139 *Id.* § 716(m), 124 Stat. at 1651 (codified at 15 U.S.C. § 8305(m)).

140 *Id.* § 111, 124 Stat. at 1392 (codified at 12 U.S.C. § 5321).

141 They are: Clearing House Payments Company L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System; CLS Bank International; Chicago Mercantile Exchange, Inc.; The Depository Trust Company; Fixed Income Clearing Corporation;

the Federal Reserve Board, via FSOC, with supervisory authority over nonbank SIFIs, a designation that depends in part on the relative derivative exposure of covered entities.¹⁴²

F. Effects

1. Derivatives Regulation as International Regulation

In the past, derivatives were either ignored by regulators or forbidden from their scrutiny, even as the size of the market exploded, and high profile collapses of derivatives-trading institutions like Long-Term Capital Management hinted at the risks inherent in this market expansion.¹⁴³ The approach taken, if any approach was taken, was laissez-faire, considering derivatives markets as engines for capital formation and economic growth. Many of the rules limiting trading in those markets were generated by private ordering.¹⁴⁴

Title VII, although adopting many of the tenets of regulated capital markets that the SEC and CFTC currently use, does something different. It embodies a regulatory approach that pursues safety and soundness. The gestalt is banking regulation rather than capital markets regulation, even as the old capital markets regulators have been given authority over the derivatives markets and the important participants in it.¹⁴⁵

What the “bankization” of the paradigm of derivatives regulation, and Dodd-Frank particularly, does, is to make it possible for derivatives regulation to be placed in an international context. In this sense, Dodd-Frank changes the traditional American laissez-faire policy towards derivatives and replaces it with a more European corporatist, safety and soundness paradigm for regulation.

ICE Clear Credit LLC; National Securities Clearing Corporation; and the Options Clearing Corporation. See FIN. STABILITY OVERSIGHT COUNCIL 2012 ANN. REP., app. A, at 145.

¹⁴² FSOC has the authority to “require” supervision by the Federal Reserve of certain non-bank financial companies that may pose risks to the financial stability of the U.S. in the event of their material financial distress or failure. Dodd-Frank Act § 112(a)(2)(H), 124 Stat. at 1395 (codified at 12 U.S.C. § 5322(a)(2)(H)). FSOC determines that a U.S. nonbank financial institution shall be subject to supervision by the Federal Reserve based on a two-thirds vote, including an affirmative vote by the Treasury Secretary, that financial distress at the institution could pose a threat to the financial stability of the United States. *Id.* § 113(a)(1), 124 Stat. at 1398 (codified at 12 U.S.C. § 5323(a)(1) (Supp. IV 2011)).

¹⁴³ For an interesting and comprehensive account of the failure of the hedge fund, which lost a bet on Russian currency options, see ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2000).

¹⁴⁴ See *supra* Part I.

¹⁴⁵ See *supra* Part II.A–D.

The international impetus behind the statute is apparent in the G20's announcement before the passage of Dodd-Frank that it would work to create common standards of derivatives. In Pittsburgh in 2009, the G20 leaders made the following commitment:

All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the [Financial Stability Board] . . . to assess . . . implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.¹⁴⁶

Of course, these are the requirements of Title VII as well.¹⁴⁷ Moreover, Congress directed the Commissions (and prudential regulators) in section 752(a) of the legislation to “consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation . . . of swaps, security-based swaps, swap entities, and security-based swap entities” as appropriate in order to “promote effective and consistent global regulation of swaps and security-based swaps”¹⁴⁸

And the international effort continues. In the final communiqué from the 2012 Los Cabos summit, the G-20 leaders reaffirmed their commitment to all of the matters cited in Pittsburgh: standardized derivative contracts traded on exchanges, cleared through central counterparties, reported to trade repositories, and, in cases where derivatives contracts are not centrally cleared, higher capital requirements on both sides of the trade.¹⁴⁹

The SEC and the CFTC, in their January 2012 joint report on international swap regulation, stated that “[t]he global nature of OTC derivatives requires comprehensive international cooperation and coordination.”¹⁵⁰ Federal Reserve Board member Daniel Tarullo has

¹⁴⁶ Leaders' Statement, The Pittsburgh Summit 9 (Sept. 24–25, 2009), http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

¹⁴⁷ See *supra* Part II.A–D.

¹⁴⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 752(a), 124 Stat. 1376, 1749 (2010) (codified at 15 U.S.C. § 8325 (Supp. IV 2011)).

¹⁴⁹ James Hamilton, *G-20 Calls for Globally Consistent Regulation of OTC Derivatives*, JIM HAMILTON'S WORLD OF SEC. REG. (July 3, 2012, 3:43 PM), <http://jimhamiltonblog.blogspot.com/2012/07/g-20-calls-for-globally-consistent.html>.

¹⁵⁰ U.S. COMMODITY FUTURES TRADING COMM'N & SEC. & EXCH. COMM'N, JOINT RE-

also indicated that the board will assist other agencies with the “[i]mportant coordination activities” that are “occurring within international groups.”¹⁵¹

The commitment to international cooperation seems to be working. As the SEC and CFTC observed in their joint report, “[j]urisdictions with major OTC derivatives markets have taken steps toward regulating OTC derivatives—with variance in pace, but with consistency among many of the ultimate policy goals.”¹⁵²

The fact that policy for derivatives is being set internationally, rather than by Congress and domestic agencies, is interesting in its own right. But it also offers a twist on this Article’s observation that Title VII is meant to work as a thematic shift in derivatives regulation towards a safety and soundness paradigm. That paradigm, it seems, is one that comes more from foreign, particularly European, markets than domestic ones. The European vision of banks serving as utilities for the rest of the economy, rather than as engines of economic growth in their own right, is particularly amenable to the paradigm shift reflected in Dodd-Frank.¹⁵³

The transformation from capital formation to safety and soundness is also an interesting one because it is a change in approach for capital markets oversight. Overseeing such markets under the *weltanschauung* of financial regulators like the Federal Reserve and Department of the Treasury is not an easy matter. Market regulators may find their standard tools, such as antifraud rules, margin requirements, and the retention of records that the CFTC already requires for capital markets participants (as well as commodities traders), insufficient in light of Dodd-Frank’s direction.

Instead, the statute has embraced capital adequacy requirements for both swap dealers and major swap participants.¹⁵⁴ It has created a mechanism—the FSOC—that subjects the vast majority of American

PORT ON INTERNATIONAL SWAP REGULATION 1 (2012) [hereinafter CFTC & SEC JOINT REPORT], available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf.

¹⁵¹ *Building the New Derivatives Regulatory Framework: Oversight of Title VII of the Dodd-Frank Act: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 1 (2011) (statement of Daniel K. Tarullo, Governor, Bd. of Governors of the Fed. Reserve Sys.).

¹⁵² See CFTC & SEC JOINT REPORT, *supra* note 150.

¹⁵³ See Carla Main, *EU Bank Capital, Banks as ‘Utilities,’ Intel: Compliance*, BLOOMBERG (Apr. 26, 2012, 8:03 AM), <http://www.bloomberg.com/news/2012-04-26/eu-wide-bank-capital-banks-as-utilities-intel-compliance.html>.

¹⁵⁴ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 731, § 4s(e), 124 Stat. 1376, 1704 (2010) (codified at 7 U.S.C. § 6s(e) (Supp. IV 2011)).

dealers to safety and soundness supervision.¹⁵⁵ And it encourages, through margin, disclosure, business conduct regulations, and the like, reliance on the claims of those who hoped that Dodd-Frank would result in standardized, rather than bespoke, judgments in multi-defendant disputes.¹⁵⁶ It has engaged in Glass-Steagal-like regulation of the activities that major derivatives players can engage in.

The approach is striking, and reflected by the purpose of Title VII. Worrying about safety and soundness in a disaggregated market with many traders (though not so many market makers) is a relatively novel function for regulators like the SEC and CFTC. The SEC, for that matter, has been roundly criticized for the ineptness of its supervision of investment banks for safety and soundness, especially given the performance of the investment banks before and during the 2008 financial crisis.¹⁵⁷ Large new regulatory programs are not always a blessing to be embraced—they can fail for lack of diligence or understanding, because of regulatory capture, or for a number of other reasons.¹⁵⁸

2. *Derivatives Regulation as Market Deference*

But perhaps a retort to skeptics of the SEC and CFTC as effective supervisory regulators is that the nature of safety and soundness regulation promulgated by Dodd-Frank draws heavily from the private market mechanisms that characterized early derivatives markets. This is the other principal facet of derivatives regulation under Dodd-Frank. As noted above, the CBOT and others have, for over a century, employed private control mechanisms to help assess and mitigate excessive risk taking by exchange members.¹⁵⁹ These initially came in

¹⁵⁵ See *id.* §§ 111–123, 124 Stat. at 1392–1412 (codified at 12 U.S.C. §§ 5321–33 (Supp. IV 2011)).

¹⁵⁶ See *id.*

¹⁵⁷ See, e.g., Bethany McLean, *The Meltdown Explanation that Melts Away*, REUTERS (Mar. 19, 2012), <http://blogs.reuters.com/bethany-mclean/2012/03/19/the-meltdown-explanation-that-melts-away/>. For a review by the former SEC chair of the program, see Press Release, U.S. Sec. & Exch. Comm'n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>. For a discussion of the SEC's supervision of investment banks, see Zaring, *supra* note 114; see also Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 101 (2009) (“[T]here is reason to believe that the SEC’s adaptation of the Basel II Capital Accord from commercial banking to investment banking failed to appreciate the different capital structures and business operations of the two types of institutions.”).

¹⁵⁸ Although one of us thinks that the handwringing about the problems of regulation can be overstated. See David Zaring, *Regulating by Repute*, 110 MICH. L. REV. 1003, 1003–06 (2012).

¹⁵⁹ See *supra* Part I.A.

the form of member sanctions, such as the loss of trading privileges in the event of default, and gradually matured into exchange and clearinghouse ownership requirements.¹⁶⁰ The mutualization of risk through shared ownership provided effective incentives for members to monitor the trading conduct and financial conditions of their fellow members.¹⁶¹ Transparency was ensured by requiring members to submit their financial records for inspection in the event there was any question about their solvency.¹⁶²

The safety and soundness regime that Dodd-Frank, in some ways, entrusts to the classic capital markets regulators has a far greater potential for voluntary enforcement and compliance by private actors (i.e., members of the exchanges and clearinghouses) than does some other kinds of banking-style regulation. The private market mechanisms make the job of the SEC and CFTC somewhat less onerous, or at least align the incentives of market participants with the regulatory objective of financial system stability. Even the various capital adequacy and margin requirements that will be promulgated for swap dealers, major market participants, and clearinghouses have a history of private sector analogs.¹⁶³ It is perhaps a bridge too far (or too soon) to say that this regime will be self-enforcing, but clear incentives nevertheless remain for individual derivatives market participants to endorse the new regulatory framework that, in some sense, formalizes many existing incentives for reducing systemic risk.

More optimistically then, Title VII leverages the traditional regulatory strengths of the SEC and CFTC as capital markets regulators to enhance the existing incentive structures of private participants in the derivatives markets and further the safety and soundness regulatory agenda. One reasonable critique of the pre-Dodd-Frank shadow banking markets, including derivatives, is that the effectiveness of private monitoring of counterparty risk broke down in a catastrophic way as a result of reliance on third-party monitors (credit rating agencies) or simply the exploding volume of trading.¹⁶⁴ This is perhaps seen most starkly in the failure of the repo markets, the markets for short-term credit that, until then, provided a critical source of liquidity

¹⁶⁰ See *supra* Part I.A.

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ See Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* 28–29 (Int'l Ctr. for Fin. at Yale Sch. of Mgmt., Working Paper No. 09-14, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1440752.

to the financial system.¹⁶⁵ In their classic account of the collapse of the repo markets, Professors Gorton and Metrick catalogue the loss of liquidity that resulted when this market shifted from information insensitive securities to information sensitive securities.¹⁶⁶

“Information insensitivity” means the securities are immune from information asymmetry or adverse selection when traded, and no trader has an incentive to create private information about the security.¹⁶⁷ In the case of an economic shock, however, information insensitive securities become information sensitive, with counterparties demanding higher collateral or margin requirements to avoid adverse selection.¹⁶⁸ The resulting deleveraging and loss of confidence is analogous to a bank run. Stated differently, the response to information asymmetry in this context was heightened counterparty monitoring manifested as an expansion of risk buffers to effectively return to information insensitivity. As Gorton and Metrick note, “[I]liquidity requires symmetric information, which is easiest to achieve when everyone is ignorant.”¹⁶⁹

Dodd-Frank’s derivatives regime is perhaps ultimately directed at mitigating instances of extreme “customer monitoring”¹⁷⁰ during financial panics (that is to say, bank runs) by reducing ignorance-based information asymmetries. The various reporting and registration requirements for derivatives market participants, including significant customer level trade reporting to a derivatives trade repository and the Global Initiative to Establish a Legal Entity Identifier, spearheaded in the United States by FSOC’s Office of Financial Research,¹⁷¹ seem intended to add an unprecedented level of transparency to the derivatives marketplace. Member-owned exchanges and clearinghouses provide for the mutualization of risk and enhance the ability of participants to effectively monitor each other’s behav-

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ Gary Gorton & Andrew Metrick, *Haircuts*, 92 FED. RESERVE BANK OF ST. LOUIS REV. 507, 508, 515 (2010).

¹⁶⁸ *Id.* at 508.

¹⁶⁹ *Id.* at 515.

¹⁷⁰ Gary Gorton & Donald J. Mullineaux, *The Joint Production of Confidence: Endogenous Regulation and Nineteenth Century Commercial-Bank Clearinghouses*, 19 J. OF MONEY, CREDIT & BANKING 457, 463 (1987).

¹⁷¹ Press Release, U.S. Dep’t Treas., Office of Financial Research Issues Statement on Progress to Date and Next Steps Forward in Global Initiative to Establish a Legal Entity Identifier (Aug. 12, 2011), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1275.aspx>.

ior.¹⁷² Both private and regulatory monitoring of the derivatives markets—at the level of understanding particular to underlying and counterparty risks—broke down as a practical matter with the explosion of the size of the marketplace and the lack of any significant reporting obligation. Although bank supervisors ostensibly examined covered institutions for credit exposure related to capital adequacy assessments, external third party monitoring became largely ineffective, as evidenced by its eventual failure.¹⁷³ Indeed, as credit rating agencies grew in prominence, the task of counterparty risk assessment was disintermediated and outsourced away from the contracting parties.¹⁷⁴

Unfortunately, the push toward transparency that is the hallmark of so much of Dodd-Frank also introduced a greater consolidation of the derivatives marketplace that may ultimately bear on the substantive goals of regulation in reducing systemic risk. For example, the Commissions now may require swaps to be centrally cleared and non-cleared derivatives are subject to greater margin or capital requirements to compensate for additional default risk, the effect of which will be to force a greater volume of derivatives transactions onto centrally cleared exchanges.¹⁷⁵ And the push-out rule will require banks with federally-insured deposits to locate all of their non-hedging derivatives activities in a separately capitalized subsidiary.¹⁷⁶

The result is elegant from a regulatory design perspective; the previously opaque and byzantine derivatives market now can be kept under careful watch in the few entities where it still exists in any form that might threaten financial stability—clearinghouses and separately capitalized bank subsidiaries. But this arrangement arguably distorts private market incentives and risks in important ways that may be antithetical to the safety and soundness goals of Dodd-Frank.

¹⁷² See *supra* Part I.A.

¹⁷³ See DARRELL DUFFIE, ADA LI & THEO LUBKE, FED. RESERVE BANK OF N.Y., STAFF REP. NO. 424, POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE 4 (2010) (discussing the failure of dealers to monitor their portfolios); Michael O'Bryan, *The Current State of Europe's Derivative Markets Regulation*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (June 16, 2012, 8:42 AM), <http://blogs.law.harvard.edu/corpgov/2012/06/16/the-current-state-of-europes-derivative-markets-regulation/> (noting the failure of third party clearing operations in the European markets).

¹⁷⁴ DEUTSCHE BÖRSE GRP., *THE GLOBAL DERIVATIVES MARKET: A BLUEPRINT FOR MARKET SAFETY AND INTEGRITY* 14–15, 25–26 (2009) (describing the role of third party collateral managers).

¹⁷⁵ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, secs. 723(a)(3), 731, §§ 2(h)(1)(A), 4s(e), 124 Stat. 1376, 1675, 1703 (2010) (codified at 7 U.S.C. §§ 2(h)(1)(A), 6s(e) (Supp. IV 2011)).

¹⁷⁶ See *supra* notes 112–14 and accompanying text.

Clearinghouses will become systemically important, or at least systemically relevant entities, as previously discussed.¹⁷⁷ And the banking industry as a whole may be viewed as more fragile after Dodd-Frank because derivatives subsidiaries are no longer able to draw on depository assets to shore up short-term losses or the Federal Reserve Bank.¹⁷⁸ Diversification is a bedrock principle of financial economics and a seemingly odd principle to aggressively thwart when creating a new financial institution regulatory structure. Consolidating particular risk activities into neat regulatory bundles serves the enticing goals of jurisdictional clarity and regulator accessibility to the conduct of those activities, but the price of regulatory elegance may well be increased brittleness in the financial system.

CONCLUSION

Dodd-Frank's new derivative regime seeks to treat the major players in the derivatives markets as systemically important financial institutions that must be overseen for safety and soundness in order to prevent another panic in the banking system. This kind of regulation is new, but the methods adopted to implement the regulation are largely market-based tools. A dramatic shift in emphasis has been accompanied by an incremental shift in methods. The juxtaposition between the new regulatory approach and the market-based tools to achieve its goals is interesting, but there are other concerns as well. The international aspects of the approach may be a harbinger of future regulatory approaches—that is a fine, and probably an inevitable development. The risks of the new approach lie, however, in the potential concentration of risks in the newly centralized counterparties; it is in these institutions that the novelty of Dodd-Frank's goals, the familiarity of the tools used to pursue those goals, and the risks and potential of the new approach lie.

¹⁷⁷ See *supra* notes 125–26 and accompanying text.

¹⁷⁸ See, e.g., Arthur E. Wilmarth Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951 (2011) (identifying this possibility while objecting to it); see also Bob Ivry, Hugh Son & Christine Harper, *BofA Said to Split Regulators over Moving Merrill Derivatives to Bank Unit*, BLOOMBERG (Oct. 18, 2011, 12:56 PM), <http://www.bloomberg.com/news/2011-10-18/bofa-said-to-split-regulators-over-moving-merrill-derivatives-to-bank-unit.html>.