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.[5]

In the shadow of the financial crisis of 2008 ("*Crisis*"), these theories have proven gravely false,[6] ushering in nearly cataclysmic economic consequences. Alan Greenspan, the former chairman of the Federal Reserve and noted free market proponent, admitted that a basic premise of the free market (that firms have the enlightened self-interest to monitor their own risk exposure) failed.[7]

Although the scope of the destruction levied on the U.S. economy by financial derivative contracts ("*Derivatives*") is still being assessed, the general consensus trends heavily towards viewing those instruments as a cornerstone of the Crisis.[8] The vastly unregulated market grew tremendously from 2001-2007, fueling the real estate asset bubble (and its eventual explosion) by multiplying systemic risk in the financial system.[9] The market toxicity of many exotic Derivatives is highly substantiated; however, the legislative response in the wake of the Crisis has been lackluster. Compounding the issue is the realization that time

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A. An Overview of Derivatives

Derivatives are financial contracts that allocate risk from one investor to another, generally not involving a transfer of principal or title.[14] Misunderstood by the public, Derivatives and the corollary Wall Street bonuses have become easy scapegoats for the Crisis, directing incendiary populist rage toward the financial sector.[15] Contrary to current popular opinion, Derivatives have existed for thousands of years[16] and do play a useful role in hedging risk, particularly interest rate fluctuations.[17] For example, when used responsibly, interest rate swaps and currency swaps can help governments and firms balance variations in borrowing costs by keeping interest rates or currency rates homogenous.

financial firms have failed under the weight of Derivatives on their books.[20] Although some Derivatives trade on exchanges, most notably the Chicago Mercantile Exchange, current estimates place

(simply, bundled portfolios) of other CDO's.[26] The risk of either instrument is amplified when multiple levels of Derivatives are usedŠ*e.*, CDS's used to insure CDO's and CDO's squaredŠ now notorious transaction that heavily contributed to the insurer side of the Crisis.[27] On the investment banking side, the failures of Lehman Brothers and Bear Stearns resulted from a run on their over the counter ("*OTC*") Derivative counterparties.[28] Moreover, in the accounting sphere, Derivatives can enable governments and firms to obtain financing without adding liabilities to their balance sheets, as demonstrated in the latest European debt crisis.[29]

Another explanation relates to the influx of "quants" into finance during the last several decades.[30] These math and physics PHD holders created increasingly complex mathematical models to circumvent the minimal regulations placed on Derivatives under the CFMA.[31] As a testament to the power of that shift in human capital, a strong relationship exists between the explosion of Derivatives between 2001 and 2007 and the creation of the "Gaussian Copula" function. The Gaussian formula assessed the

risk on large pools of Derivatives based on historical data, concluding with a final "correlation number" that was voraciously consumed by Wall Street in the rampant pursuit of further securitization.[32] By 2007, the correlation number became ubiquitous in finance, but its fatal flaw surfaced when the underlying assets defaulted, failing to conform to the historical data the correlation represented.[33]

B. Derivatives and Financial Leverage

When contemplating the origins of the Crisis, many regulators point to the eradication of Glass-Steagall's wall between banking, insurance, and investment banking, which led to the subsequent creation of financial entities that were "too big to fail."[34] An interesting counter argument examines the Canadian banking system and its minimal (by comparison) losses, because, as opposed to the U.S., Canada is dominated by five "too big to fail" banks.[35] The main difference, it seems, is the regulatory inability of Canadian banks to employ extreme leverage or securitize (resell claims on) their loans outstanding.[36] Pre-Crisis leverage figures seem to support this argument: at the peak, the median large bank had debt of 37 times its equity.[37]

32. Overbye, *supra* note 30 ("[U]sing Li's copula approach meant that ratings agencies like Moody's—or anybody wanting to model the risk of a tranche—no longer needed to puzzle over the underlying securities. All they needed was that correlation number, and out would come a rating telling them how safe or risky the tranche was.")

33. *Id.*

34. *See* Paul Volcker, Op-Ed, *How to Reform Our Financial System,* N.Y. TIMES, Jan. 31, 2010, at WK11, *available at* http://www.nytimes.com/2010/01/31/opinion/31volcker.html?scp=3&sq=volcker&st=cse ("The phrase 'too big to fail' has entered into our everyday vocabulary. It carries the implication that really large, complex and highly

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In general, leverage allows financial institutions and investors to use diminutive amounts of capital to take much larger risks in the market.[38] Although leverage can make it more cost effective to hedge risk, it also allows for much cheaper speculation.[39] Randall Dodd, of the Derivatives Study Center of the Financial Policy Forum, provides a basic example:

> Instead of buying $1 million of Treasury bonds or $1 million of stock, an investor can buy futures contracts on $1 million of the bonds or stocks with only a few thousand dollars of capital committed as margin (the capital commitment is even smaller in the over-the-counter derivatives markets). The returns from holding the stocks or bonds will be the same as holding the futures on the stocks or bonds. This allows an investor to earn a much higher rate of return on their capital by taking on a much larger amount of risk.[40]

As the Crisis aptly demonstrated, an increased ability to take risk raises the probability that institutions will fail, which due to

these instruments can amplify risk with leverage and diffuse it around a complex chain of investors, imbuing systemic hazards. Although many Derivatives comprise a necessary part of the financial system, the Crisis has illuminated the folly of accepting an efficient Derivative market that needs little regulation.

III. THE CFMA

> I think we will look back in 10 years' time and say we should not have done this but we did because we forgot the lessons of the past, and that that which is true in the 1930's is true in 2010. . ..[W]e have now decided in the name of modernization to forget the lessons of the past, of safety and of soundness.[43]

At the legal heart of the Derivatives regulatory controversy is the CFMA. To understand the CFMA's context, one must delve into the political and economic climate at the millennium, where thirty years of deregulatory zeal culminated by seducing policy makers and market participants with the notion that modern financial instruments had eliminated the risks of the past.

A. Legislative History and Political/Economic Climate

Signed into law by President Clinton on December 21, 2000, the CFMA mutated the regulatory framework covering Derivatives by effecting changes in the Securities Act of 1933[44] ("*Securities Act*"), the Securities Exchange Act of 1934[45] ("*Exchange Act*"), Commodity Exchange Act

repealed Glass-Steagall's hermetic seal between banking, investment banking, and insurance. That monumental gift to financial firms concluded decades of lobbying and billions spent to realize the repeal.[62] Approval of the CFMA occurred in December 2000, just one month before Bill Clinton's term ended, and emails between Enron executives, lobbyists and corporate counsel show a coordinated effort to control the process.[63] The emails also reveal the extreme influence Enron had with Senator Gramm, and the length of Wendy Gramm's involvement in CFTC affairs.[64]

B. Key Provisions

The CFMA made two notable (and arguably disastrous) changes to previous regulation of Derivatives markets by: (1) exempting certain OTC Derivatives from the jurisdiction of the CFTC,[65] and (2) allowing futures contract trading based on single stocks or indices.[66] The CFMA contains four titles that limit the scope of the CEA and amend the CEA, the Securities Act, the Exchange Act and the Shad-Johnson Accord.[67]

1.Treasury Amendment

Before the CFMA's enactment, foreign currency transactions and many CDO's were excluded from the CEA pursuant to the "Treasury Amendment."[68] This provision created uncertainty concerning financial instrument coverage,[69] particularly as new and exotic variations began to explode onto the market during the

62. *Id.*; *see also* Montopoli*, supra* note 57.

63. Lipton, *supra* note 61.

64. *Id.*

65. 15 U.S.C. § 77(b)(1) (2000).

66. § 77(b)(1); *see also* Dean Kloner, *The Commodity Futures Modernization Act of 2000*, 29 SEC. REG. L. J. 286, 286 (2001), *available at* http://www.stroock.com/SiteFiles/Pub134.pdf.

67. *See generally* Consolidated Appropriations Act, 2001 Pub. L. No. 106-554, 114 Stat. 2763 (2000).

68. 7 U.S.C. § 2(a) (2010).

69. *See* John Riley & Michael B. Garcia, *The Commodity Futures Modernization Act of 2000*, SIMPSON THATCHER & BARTLETT, LLP, at 1 (Feb. 2, 2001), http://www.stblaw.com/content/publications/pub370.pdf ("Section 2(a)(1)(A)(ii) of the CEA, excluded from the CEA foreign currency transactions, as well as security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, and mortgages or mortgage purchase commitments.").

1990's. Accordingly, the CFMA allows a clear exclusion from CFTC jurisdiction for any of the enumerated transactions between "eligible contract participants,[70]" ("*ECP*") a term defined broadly to allow any individual or entity meeting certain financial criteria to enter into a transaction for risk management.[71]

2. Commodities

The CFMA continues a laissez-faire approach by extending many exemptions and exclusions to OTC Derivatives, Swaps, and commodities. A notable broad exclusion removes CEA jurisdiction over transactions involving an "excluded commodity,"[72] as well as any contracts in "exempt commodities"[73] such as energy and metals, allowing those commodities to be traded in the OTC market with little regulation.[74] That notorious provision garnered the "Enron Loophole" moniker after the disastrous collapse of Enron.[75]

Another subsection relates to CDS's and other negotiated "swap" agreements, excluding these credit Derivatives from the definition of a "security" under the Securities Act and the Exchange Act when entered into by ECP's.[76] Aside from that exclusion, the vast majority of swaps would fall under the SEC's jurisdiction per the "investment contract" definition of a security,[77] because in a swap agreement profit is derived from the efforts of others.[78]

70. 7 U.S.C. § 2(d) (2010).

71. Riley & Garcia, *supra* note 70.

72. *Id*. ("[T]he CFMA defines 'excluded commodity' to include: an interest rate, exchange rate, currency, security, security index, credit risk, debt or equity instrument, index or measure of inflation, or a host of other measures not within the parties' control.").

73. 7 U.S.C. § 2(h).

74. Kloner, *supra* note 67, at 290.

75. *See* Lipton, *supra* note 61.

76. Commodiy Futures Modernization Act § 206(C); Riley & Garcia, *supra* note 70, at 2.

77. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2010); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2010).

78. *See* Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. RICH. L. REV. 647, 664 (2010); SEC v. W.J. Howey, 328 U.S. 293, 301 (1946) (noting "[T]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative, or whether

3. Hybrid Instruments

The CFMA also extends regulatory exclusions to certain "Hybrid Instruments,"[79] defined as "securit[ies] having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities."[80] The exclusion applies if the hybrid instrument is "predominantly a security."[81] Under the statute, a hybrid instrument is predominantly a security if: (a) the issuer receives payment in full of the purchase price contemporaneously with delivery of the instrument; (b) the purchaser is not required to make any payment to the issuer over the purchase price (e.g., margin or settlement payments); (c) the issuer of the hybrid is not subject to mark-to-market margining requirements; and (d) the hybrid is not marketed as a futures contract or option thereon.[82] This exclusion removed hybrid instrument transactions from the more stringent requirements imposed by the CFTC.

5. Derivative Transactions Execution Facilities

Finally, the CFMA creates a tiered regulatory approach to different markets, particularly the contracts market and futures exchanges.[87] The contracts market garners the highest amount of regulation, while less regulation applies to "Registered Derivatives Transaction Execution Facilities" ("*RDTEF*") and exempt "Boards of Trade." For example, a certain CFMA "innovation" allows ECP's operating a RDTEF to trade futures and options on any commodity and circumvent the more stringent restrictions that would be applicable to these instruments in the contracts market.[88] Even less regulation applies to exempt Boards of Trade, although participants are restricted to ECP's, and products are restricted to those that have an "inexhaustible deliverable supply" and are not likely to be subject to manipulation.[89]

C. Regulatory Disconnect Between the CFTC and SEC

Prior to the CFMA's enactment, agency regulation of Derivatives was characterized by a void of legal uncertainty between the SEC and the CFTC.[90] That regulatory gap developed because some Derivatives fell into the securities category, while others fell into the commodity futures category.[91] Some jurisdictional disputes were resolved in the 1982 Shad-Johnson Accord, allowing the SEC to retain jurisdiction over securities and options, while the CFTC would continue to regulate futures contracts and CDS's.[92] Until the 1980's, regulations only allowed Derivative trading in regulated commodities markets; however,

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Stat. 2294 (1983) (codifying Shad-Johnson Accord), *with* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000).

87. *See generally* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365.

88. See 7 U.S.C. § 7a(a) *See* Kloner, *supra* note 67, at 294–95.

89. *See* 7 U.S.C. § 7a-3(b)(1); *see also* Kloner, *supra* note 67, at 295.

90. *See*, *e.g.*, U.S. COMMODITIES FUTURES TRADING COMM'N AND SEC. & EXCH. COMM'N, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION 2 (2009), *available at* http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

91. See *id. at* 2–3.

92. *See* Securities Acts Amendments of 1982, Pub. L. No. 97-303, 96 Stat. 1409 (1982) (amending § 2 of the Securities Act of 1933 and § 3 of the Securities Exchange Act of 1934); *see also* The Futures Trading Practices Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983).

after the Shad-Johnson Accord, certain CFTC exemptions allowed the OTC Derivative market to expand in the 1990's.[93] This laissez-faire attitude, espoused by policy makers, culminated with the CFMA's exemption of most OTC Derivatives under an efficient market rationale.[94] Jurisdictional issues between the SEC and CFTC continue, although a recent joint report of the two agencies seeks uniformity in future regulation of many Derivative varieties.[95]

IV. THE NEED FOR DERIVATIVE TRANSPARENCY

A. *Current State of Derivative Markets*

The Crisis continues to initiate considerable debate on the transparency and disclosure of Derivatives in financial markets. The CFMA relaxed regulatory standards and permitted increasingly sophisticated Derivatives to remain undetected by regulators and investors, rendering market participants unable to grasp the underlying structure of the assets or the risks involved. For instance, according to third quarter 2009 figures compiled by the Office of the Comptroller of the Currency, just five U.S. banks hold 97% of all U.S. bank Derivatives positions in terms of notional values, and 88% of the total net credit risk exposure in event of default.[96] The total notional values of the derivatives held by these commercial banks topped $204 trillion, dispersed among JPMorgan Chase ($78 trillion); Goldman Sachs ($42 trillion); Bank of America ($40 trillion); Citibank ($32 trillion) and Wells

93. *See* Thomas Lee Hazen, *Filling a Regulatory Gap: It is Time to Regulate Over-The-Counter-Derivatives*, 13 N.C. BANKING INST., 123, 128 (2009), *available at* http://studentorgs.law.unc.edu/documents/ncbank/volume13/hazen.pdf.

94. *See id.*

95. *See generally* U.S. COMMODITY FUTURES TRADING COMM'N & U.S. SEC. & EXCH. COMM'N, *supra* note 91.

96. OFFICE OF THE COMPTROLLER OF THE CURRENCY, ADMINISTRATOR OF NATIONAL BANKS, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES THIRD QUARTER 2009 1 (2009), *available at* http://www.occ.treas.gov/ftp/release/2009-161a.pdf ("[N]onetheless, derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Five large commercial banks represent 97% of the total banking industry notional amounts and 88% of industry net current credit exposure.").

Fargo ($4.5 trillion).[97] The most recent statistics on global OTC Derivatives in June 2009 from the Bank for International Settlements place the market near $604 trillion.[98]

Many question the social value of Derivatives and commodity speculation in general, arguing, for example, that incentives are skewed when traders can reap $100 million bonuses by storing oil offshore in supertankers, betting the price of oil will exceed the storage costs during a fixed time period.[99] Recent revelations concerning Wall Street's culpability in Greece's sovereign debt default have also bolstered arguments that Derivatives (as currently regulated) produce calamitous rather than copacetic financial results.[100] The irony of the Greek crisis could not be more pronounced: Goldman Sachs and other Wall Street banks quietly assisted Greece in masking billions in debt with interest rate Derivatives in 2001, and in 2009 immediately prior to Greece's default.[101] Simultaneously, a Goldman Sachs subsidiary exchange in London facilitated heavy trading in CDS's on Greek debt, signaling a rise in the cost of these insurance contracts, which made it harder for Greece to sell bonds and in turn affected their ability to borrow.[102] In essence, Goldman Sachs profited from the

97. *Idr r o w .*

original Derivative package, and then profited from CDS contracts on a debt catastrophe they engineered. Indeed, the same self-fulfilling gambles may undermine other indebted Eurozone nations such as Spain, Portugal and Italy as CDS traders and hedge funds turn their attention elsewhere.[103]

After months of political posturing and debate, many of the OCDMA provisions passed the House of Representatives on December 11, 2009 in the "Derivatives Markets Transparency and Accountability Act"[108] of the Wall Street Reform and Consumer Protection Act of 2009[109] ("*House Bill*").[110] All regulatory hopes now hinge on a reconciliation of the House Bill and "The Over-the-Counter Derivatives Markets Act"[111] of the "Restoring American Financial Stability Act of 2009"[112] ("*Senate Bill*"), currently in a discussion draft iteration in the Senate.[113] In some aspects, both bills affect some positive changes in the regulation of Derivatives and repeal portions of the CFMA. However, many loopholes exist and the current odds of reconciling the t8(a)-1(ny)]TJ0.w 13.2590 0 7.98/j7p9Mr

case of Lehman Brothers.[124] One way to reduce risk from counterparty failure is by centrally “clearing” CDS’s through a centralized clearing counterparty (“*CCP*”).[125] In a CCP swap transaction, both counterparties assitdtiey ts e (C who a)Tj0.04070.0183363 Tw t 7475 -1.0850

4. Position Limits

Finally, on the leverage front, both bills authorize the CFTC and SEC to establish "position limits" on both swaps and security based swaps.[133] That would allow either agency to impose limits on the size of positions that a market participant may hold in a futures contract, an option on a futures contract, or an economic equivalent.[134] By itself, that provision would represent an effective tool against excessive leverage in the commodities markets; however, the House Bill contains a narrow (yet ambiguous) exception for "bona fide hedge positions," which limits its otherwise broad scope.[135]

C. Closing the Loopholes

Even a cursory glance at the House Bill reveals numerous loopholes that could undermine effective regulation and sow the seeds of the next financial meltdown. Both the SEC and the CFTC have articulated the same conclusion, while financial and business lobbyists applaud the bill in its current form.[136] To realize effective future regulation and circumvent the next disaster, an alteration of several glaring loopholes is necessary before a final bicameral bill passes.

First, unless otherwise determined by the CFTC and the Treasury, both bills exclude foreign exchange Derivatives (swaps and forwards) from the definition of "swap,"[137] effectively continuing a policy of lax regulation in this large market.[138] On August 17, 2009, in a letter commenting on the OCDMA, CFTC Chairman Gary Gensler advised Congressional leaders that foreign

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133. *Id.* at 7 (discussing H.R. 4173, 111th Cong. § 3113, and S. 3217, 111th Cong. § 720).

134. *Id.*

135. H.R. 4173, 111th Cong. § 3113; Rae, *supra* note 111 at 7 (noting that the exception is limited "to a transaction (i) that, among other things, represents a substitute for a transaction made or to be made at a later time in a physical marketing channel . . . or (ii) that reduces the risks attendant to a position resulting from a swap executed opposite a counterparty for which the transaction would meet the standard described in clause (i).").

136. *See generally* Teena Seeley & Dawn Kopecki, *Derivatives Bill's Loophole May Exempt Most Firms, Gensler Says*, BLOOMBERG (Oct. 8, 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=a7fAFtZGaGAk.

137. H.R. 4173, 111th Cong. § 3101; S. 3217, 111th Cong. § 711..

138. *See* Morrison Foerster, *supra* note 117, at 1.

characterizes the relationship between government and banking systems as a cyclical "doom loop" where governments always have (and always will) come to the rescue when financial "innovation" fails.[156]

Recent news reports show little progress in the Senate based on disagreements about the Senate Bill's inclusion of a new consumer protection agency, a feature opposed by Republicans and bank lobbyists.[157] Although statements by ranking members of the Senate Banking Committee portend the possibility of a bill passing this year,[158] there are no assurances on the elimination of any exemptions. Based on the current iterations, some argue that the U.S. may be better off if Democrats refuse to accept such a watered down version.[159] Moreover, the recent trend of Wall Street contributions shifting to Republicans because of their opposition to many financial reforms does not bode well for bipartisan reform.[160]

RESERVE BANK OF CHICAGO TWELFTH ANNUAL INTERNATIONAL BANKING CONFERENCE ON "THE INTERNATIONAL FINANCIAL CRISIS: HAVE THE RULES OF FINANCE CHANGED?", BANKING ON THE STATE (2009), *available at* http://www.bis.org/review/r091111e.pdf.

156. *Id*. ("[S]ocialised losses are doubly bad for society . . . [T]his is a repeated game. State support stokes future risk-taking incentives, as owners of banks adapt their strategies to maximise expected profits. So it was in the run-up to the present crisis.").

157. *See, e.g.,* Kevin Drawbaugh, *Financial Reform Bill Faces Tough Slog in US Senate*, REUTERS (Feb. 27, 2010), http://www.reuters.com/article/idUSN2718350620100228 ("[U]rgent talks in the U.S. Senate on financial regulatory reform extended into Saturday, but little support emerged for the latest attempt by Democrats to compromise on a key issue -- financial consumer protection.").

158. *See* Sewell Chan, *Traction for Banking Regulation,* N.Y. TIMES, Feb. 26, 2010, at B1 (reporting that Christopher Dodd and Richard C. Shelby agree on about 90% "of everything"), *available at* http://www.nytimes.com/2010/02/26/business/26regulate.html?ref=business

159. Krugman, *supra* note 154.

160. *See* Kirkpatrick, *supra* note 59 (reporting on J.P. Morgan Chase's contribution shift, noting that "[r]epublicans are rushing to capitalize on what they call Wall Street's 'buyer's remorse' with the Democrats. And industry executives and lobbyists are warning Democrats that if Mr. Obama keeps attacking Wall Street 'fat cats,' they may fight back by withholding their cash."); *see alr*

between crises decreases.[166] Moreover, due to the sophistication and interdependency of modern markets, crises also become increasingly dangerous and expensive. If we cannot realize reform in Derivative markets soon, the lessons of the Crisis will fade into the distance and any hope of regulation will be politically untenable. That course of action will severely impair the U.S. and global economic future: in that possible future scenario, it is not a question of "if" another financial catastrophe will emerge, but "when."

166. *See, e.g.,* Robert Kuttner, *The Bubble Economy*, THE AMERICAN PROSPECT (Sept. 24, 2007), http://www.prospect.org/cs/articles?article=the_bubble_economy (reporting on financial bubbles, noting "[i]ndeed, until Congress dismantled financial regulation, the Fed was not called upon to mount these heroic rescues, which have become so common in recent years . . . [b]ut during the past quarter-century, as deregulation has turned the economy into a casino, the Federal Reserve has had to mount major rescues at least six times.")