Financial Market Destabilization and the Role of Credit Default Swaps: An International Perspective on the SEC's Role Going Forward

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Citation Details
FINANCIAL MARKET DESTABILIZATION AND THE ROLE OF CREDIT DEFAULT SWAPS: AN INTERNATIONAL PERSPECTIVE ON THE SEC’S ROLE GOING FORWARD

Janis Sarra*

I. INTRODUCTION

International financial market participants and regulators are watching as the United States attempts to come to grips with the most serious consequences of the crisis in financial markets. Multiple strategies are being used, including bailouts, bank stimulus packages, recapitalization of financial institutions, insolvency restructurings, mortgage programs, guarantees for interbank lending, and direct asset purchases. The causes of the financial turmoil are numerous and complex, but one underlying cause was activities in the credit derivatives market. Bear Stearns' financial crisis arose after it was unable to obtain further credit needed to meet its commitments under the sub-prime and derivatives markets. It was rescued through brokering efforts of the U.S. Federal Reserve and U.S. Treasury, which coordinated the merger of Bear Stearns and JP Morgan Chase. Lehman Brothers filed bankruptcy because of its sub-prime and credit default swap exposure.1 Merrill Lynch merged with Bank of America to avoid bankruptcy proceedings. The U.S. investment banks that have survived, Goldman Sachs and Morgan Stanley, for example, have become bank holding companies under jurisdiction of the U.S. Federal Reserve.2 Together, these events marked the end of major investment banks in the United States.

The fragmentation of regulation over the U.S. financial system, with

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2. Press Release, Fed. Reserve Bd. (Sept. 21, 2008), available at http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm. In the United States, the Glass-Steagall Act bifurcated banking; commercial banks were allowed to take deposits and make loans and investment banks were buying and selling securities and involved more generally in transaction-based corporate finance. Most of the prohibitions on commercial banks being engaged in securities transactions were repealed by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 & 15 U.S.C.), although the distinction had been eroded through the grant of exemptions to commercial banks to underwrite securities, and exemptions to investment banks to own commercial bank subsidiaries.
at least five oversight bodies, has arguably resulted in significant gaps in regulatory oversight. The treatment of credit default swaps is one of them. This Article explores the issue of credit default swaps, and the potential role of the Securities and Exchange Commission (SEC) going forward. Credit default swaps are the most common credit derivative product globally. The figures on the extent of the credit derivatives market vary, but they are all in the tens of trillions of U.S. dollars, of which about 80% are credit default swaps. Credit default swaps have been around for a number of years. They are financial instruments that were originally designed to manage risk exposure. However, a number of shifts in the market, including a radical increase in the speculative aspects of the market, the diminution of credit ratings, and the shift in market share from banks to hedge funds, created problems that eventually contributed to a number of financial failures. The policy question now is how to preserve the positive risk management aspects of credit default swaps while slowing the speculative aspects of the market. In relation to the SEC, the question is, what is its oversight, policy, and enforcement role with respect to such derivatives?

This Article is divided into three parts. Part II discusses credit default swaps, their recent role in financial markets and their effects on governance of corporations. Part III examines the role of the SEC historically in respect of derivatives and the current question of whether it should acquire regulatory power over credit default swaps. Part IV then suggests some additional policy considerations that should guide the SEC’s deliberations as it charts a course for the future.

II. THE CONTRIBUTION OF CREDIT DEFAULT SWAPS TO RISK MANAGEMENT

A credit default swap (CDS) is a bilateral executory derivative instruments that can be used to hedge credit risk. Under a CDS, one party, the “protection buyer,” pays a sum of money periodically to the

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3. This paper was presented at the University of Cincinnati College of Law, Symposium on New Models of Regulating the Financial Markets, Cincinnati, Ohio, April 3, 2009, examining the SEC on its 75th anniversary.

4. There are numerous kinds of credit derivatives, such as credit default swaps, collateralized debt obligations (CDOs), full and index trades, and credit-linked notes. Credit derivatives are classified as either single or multiname (basket) products. Single name credit derivatives are targeted on the credit worthiness of a single reference entity. Multiname products hedge the risk of clustered defaults in a portfolio. Elizabeth Murphy, Janis Sarra & Michael Creber, Credit Derivatives in Canadian Insolvency Proceedings, “The Devil will be in the Details” in ANNUAL REVIEW OF INSOLVENCY LAW, 2006, at 187–234 (Janis Sarra ed. 2007).

“protection seller,” usually referable to the amount of protection provided by the contract. The CDS typically refers to a “reference entity,” the company with respect to which credit protection is sought, or “reference asset” or security, the underlying assets for which protection is sought; the “credit event”, such as a payment default; the debt obligations of the reference entity whose nonpayment constitutes a credit event; and the deliverable obligations or cash settlement payment that is to be delivered on the occurrence of a credit event. The value of a CDS financial contract is based on underlying obligations of the reference entity or reference security, or indices of several such entities, securities, or obligations.

The protection seller’s obligation to pay arises on the occurrence of a credit event, most frequently, the reference entity’s default on payments owed, bankruptcy filing, or commencing restructuring proceedings. The reference entity is not a party to the CDS. A lender is able, through a CDS, to purchase protection against a borrower’s payment default. A CDS also enables the protection seller to receive income in exchange for assuming exposure to the borrower’s credit. Investors purchase a CDS to offset or insure against risk in their fixed-income portfolios, to take synthetic positions in bonds or in segments of the debt market represented by an index.

The protection buyer that is a creditor of the reference entity hedges the risk of default by that entity. In other words, if a bank lends $50 million to an auto company, it can purchase a CDS for that amount. If the auto company files for insolvency restructuring, the bank, as “protection buyer,” is paid out the value of the CDS and does not lose that value with the bankruptcy of the company. The protection buyer faces counterparty risk in that its ability to successfully protect itself against a failure or default of a reference entity depends on the protection seller’s ability to perform its obligations under the CDS. Lehman Brothers, Bear Sterns, and other failures left numerous protection buyers vulnerable when these protection sellers were unable to meet their CDS obligations.

7. The reference entity can, in reality, be a company, a governmental entity, or any other borrowing entity.
8. Murphy, Sarra & Creber, supra note 4, at 212.
10. Id. at 3.
CDSs are generally documented under the International Swaps and Derivatives Association’s (ISDA) master agreement and a schedule that parties use to supplement or modify the master agreement. Parties to a CDS often enter into a credit support annex that establishes a framework for the collateralization of credit exposures by one or both parties. The terms of an individual CDS transaction are documented in a “confirmation” that incorporates the master agreement, schedule, and credit support annex, although many definitions and terms have become highly standardized and are not negotiated.

The CDS protection seller acquires the default risk of the reference entity. The protection buyer need not suffer an actual loss to be eligible for compensation if a credit event occurs. Credit derivatives do not require either the protection seller or protection buyer to actually hold an interest in the referenced asset or entity. Therefore the protection purchased by the protection buyer can be more than, less than, or completely unconnected to its underlying exposure to the reference entity. In this respect, a credit default swap differs from a basic forward or commodities contract where there is an economic interest in the product and hedging against price fluctuations. Unlike insurance, the amount of compensation claimed under a CDS is not related to actual losses suffered by the protection buyer.

CDSs have provided an important tool for risk management. They enable banks and other financial institutions to hedge the credit risk of lending to corporations, in turn facilitating economic activity. Hedging credit risk arguably frees up funds to be lent elsewhere, making more capital available for financings, which can reduce the cost of borrowing.

There have been significant changes in the CDS market in the past five years. The original objective of managing risk of direct investment under lending portfolios was overtaken by a speculative market for buying and selling CDSs in multiples of value of the underlying reference entity. CDSs enable market participants to take “long” or “short” positions on the credit quality of a reference entity without transacting directly in the debt obligations of the company, allowing for speculation on the solvency or credit worthiness of the entity. Some counterparties participate in the CDS market to capitalize on the volatility in credit spreads during times of economic uncertainty.

Global credit derivatives exposures by ratings began shifting downward in 2000. Hedge funds increasingly took a greater share of both the buy side and sell side of the market. Hedge funds went from

3% of the market on the buy side in 2000 to 28% in 2006. As a seller, their market share grew from 5% to 32% in the same period.\textsuperscript{12} Those derivatives were then hedged in further credit derivatives in multiples of the value of the originating reference entities. Hedge funds played a role in driving credit derivatives down the credit curve. As spreads tightened and margins squeezed at the upper end of the credit curve, hedge funds shifted to more speculative investment grades and unrated exposures to preserve returns. In 2002, 36% of all credit derivatives globally were rated at AA or AAA, whereas only 8% were rated as below investment grade. Just four years later, in 2006, only 17% of credit derivatives globally were rated at AA or AAA, whereas 31% were rated below investment grade.\textsuperscript{13}

The largest players globally on both the buy side and sell side were Bear Sterns, Lehman Brothers, AIG, Merrill Lynch, and Royal Bank of Scotland.\textsuperscript{14} Notwithstanding the tremendous growth in the derivatives market from the early 1990s, there was a lack of transparency of the degree of exposure by the commercial banks, investment banks, and other market participants until tightening market conditions and lack of liquidity forced several of them to take action when they could not meet their counterparty obligations. For example, AIG's collapse was caused largely because its financial products subsidiary was unable to post additional cash collateral on its outstanding $526 billion portfolio of CDS obligations due to its overexposure.\textsuperscript{15} AIG had a sound insurance business globally, but its United Kingdom financial products operation was given wide latitude to participate in the derivatives market, and commitments with respect to derivatives pulled the entire business down. In this respect, there was a failure of governance, as AIG's board did not foresee that the amount of net exposure it had in the market was a risk to its business.

While the disruption to the global financial market in 2008 resulted in an overall decline in CDS trading volume, the dollar value of CDS transactions has continued to grow. The Bank for International Settlements (the Bank) has estimated that the total notional amount of over-the-counter (OTC) derivatives contracts outstanding was $592 trillion at the end of December 2008.\textsuperscript{16} Severely strained credit markets

\textsuperscript{12} BRITISH BANKERS'A SOC., BBA CREDIT DERIVATIVES REPORT 2006 (2006). In 2000, banks accounted 81% of the buy side and 63% of the sell side of market share; that number dropped to 59% and 44% respectively by 2006.

\textsuperscript{13} Murphy, Sarra, & Creber, supra note 4, at 195 (discussing Fitch Ratings).

\textsuperscript{14} Id.

\textsuperscript{15} AIG Insurance was required to begin to book billions of dollars of losses as the risk exposure on the CDSs it sold rose in price with the deteriorating credit position of the reference entities.

\textsuperscript{16} MONETARY & ECON. DEP'T, BANK FOR INT'L SETTLEMENTS, OTC DERIVATIVES MARKET
and multilateral netting of contracts led to a contraction of 26.9% in outstanding CDSs from the previous year.\textsuperscript{17} The Bank reports that the volume of outstanding CDS contracts fell 27% in the second half of 2008 to $41.9 trillion. Single-name contracts declined by 22.8% to $25.7 trillion while multiname CDS indices and CDS index tranches decreased 32.7%, to $16.1 trillion. Despite lower outstanding volumes, the gross market value of CDS contracts increased by 78.2%, $5.7 trillion, at the end of December 2008.\textsuperscript{18}

The Bank also reported that greater use of multilateral netting during the second half of 2008 resulted in a change in composition across CDSs, in that amounts outstanding of multiname contracts fell 32.7% to $16.1 trillion, while single-name contracts declined 22.8% to $25.7 trillion.\textsuperscript{19}

The notional amount of outstanding CDSs does not represent the actual risk in the CDS market; ISDA’s 2007 Year End Market Survey estimated the gross market (or replacement) value of outstanding CDSs to be just over $2 trillion, less than 3.5% of the notional figure. Multilateral netting helps reduce the aggregate notional size of the market to more closely approximate the actual amount at risk.\textsuperscript{20}

A majority of the CDS market is bilateral OTC transactions between dealers, including approximately twenty global commercial and investment banks.\textsuperscript{21} Intermediaries supply liquidity to the CDS market, accumulating large notional exposures that are offset with transactions with the same or different counterparties. The composition across counterparties changed in 2008. CDS contracts between reporting dealers declined 24.4%, whereas outstanding contracts between dealers and other financial institutions decreased 29.8%, and contract volumes between dealers and nonfinancial institutions decreased 47.7%.\textsuperscript{22} The

\textsuperscript{17} Id.
\textsuperscript{18} Id. at 2. Gross market values grew 95.6% to $3.7 trillion for single-name contracts and 52.5% to $2 trillion for multiname contracts.
\textsuperscript{19} Id.
\textsuperscript{22} MONETARY & ECON. DEP’T, supra note 16, at 3.
market value of contracts between reporting dealers grew by 89.3% to $3.2 trillion, representing 56.2% of the total market value of outstanding CDS contracts. The market value of contracts between reporting dealers and other financial institutions increased by 66.3%, while the market value of contracts between dealers and nonfinancial institutions increased 51%.23 Hence, while the sub-prime and asset-backed commercial paper markets collapsed during the height of the financial crisis, the CDS market suffered losses but has continued to grow. Yet its impact on both financial markets and real economic activity continues to be poorly understood.

The notional amount of the CDS market does not reflect net exposures after offsetting positions, the probability or risk of default of the reference entity, the risk that the counterparty will default on its obligations under the CDS, or the probability of recovery amounts that counterparties will collect on occurrence of such default. The lack of transparency in the market, and previous lack of a central counterparty or centralized data collection and dissemination system, means that actual risk exposure in the market is unknown. When the financial markets began to seriously deteriorate, the CDS exposures of counterparties crystallized, creating a major crisis in the ability of protection sellers to ensure coverage.

On the protection buyer side of a CDS transaction, there is no disclosure obligation with respect to information that the buyer may have regarding material adverse risk to the underlying reference entity. While the protection seller takes on that risk, in many jurisdictions there is no prohibition, as there is in securities law, not to use insider information in purchasing the swap. Equally significant, protection buyers rely on the financial viability of protection sellers so that their claims can be met in case of a credit event. Yet the protection seller is not required to disclose its capacity to settle the derivatives. In this respect, credit derivatives differ from other bilateral contracts where the credit worthiness of a counterparty is typically dealt with through negotiated credit controls, including collateral requirements, covenants, representations and warranties, and the oversight and monitoring of a credit officer of the lending entity.24

The European Union (EU) Joint Market Practices Forum published recommendations for handling nonpublic information by credit market participants, including recommending that prohibitions on insider dealing apply to dealings in any credit derivative whose value depends

23. Id.
24. Sarra, supra note 9, at 3.
on a publicly-traded security. To comply with the principles of the EU’s Market Abuse Directive, it has suggested that lenders that hedge credit risk by purchasing CDSs referencing their borrowers who possess material nonpublic information should be found subject to a duty of trust and confidence owed to their borrower. As with other financial services markets, failure to disclose material adverse risk can affect the credibility of the derivatives market. The creation of standards to require such disclosure in the credit derivative market could assist in preventing some aspects of the current financial instability.

There are significant agency issues that have arisen with respect to credit derivatives. Traditionally, a creditor’s interest in a debtor company was to receive return of its capital plus interest and fees, often premised on encouraging an ongoing credit relationship with the business enterprise. The introduction of CDSs has, in some instances, created a misalignment between the creditor’s and debtor’s interests. A creditor can lend an amount to a debtor company and then purchase CDSs many times the value of the underlying reference asset or entity. Thus the creditor has an incentive to have the debtor company fail, triggering a credit event in which the value to the creditor from settlement of the CDS is greater than repayment of the loan. If the creditor is a senior lender, it may be able to precipitate the credit event. Some of the previous willingness by lenders to not enforce covenants for a limited period to allow a debtor time to devise a business plan may be less likely now that the lender is not only fully hedged, but overhedged.

There have been problems with the credit ratings associated with CDSs. Credit rating agencies developed inadequate valuation methods to assess these products, valuing the debt in various tranches higher than the cost of the underlying asset, making them attractive to sellers, but creating new counterparty risks. Another explanation is that the agencies accepted the methodology developed by investment banks


26. Sarra, supra note 9, at 5.

27. For a full discussion, see id. at 5–7.

28. Id.

29. See Hu & Black, supra note 25. They call this over-hedging of debt “negative economic ownership.” They observe that there can also be “hybrid” decoupling, whereby investors short their shares, buying protection with credit default swaps or use a long equity position to hedge a short debt position. Id. at 665, 682.
structuring derivatives, without separate assessment. One further explanation is that credit rating agencies actively promoted synthetic derivatives, although it was a conflict-of-interest because their fees come from those that they rate, and those entities have no real choice of rating agency, given the closed market created by regulators.  

Historically, the screening and monitoring activities of lenders produced positive externalities through the bank’s decision to lend, signalling to other stakeholders the quality of the corporate governance of the borrowing company. The screening and monitoring activities of a lender produced externalities that benefited numerous stakeholders with an interest in the corporation, through the bank’s decision to lend, which signalled to potential and existing stakeholders the quality of the borrower; through the imposition of fixed obligations under the loan agreement that prevented managerial slack; through security rights that constrained the ability of managers to liquidate noncash assets or unilaterally sell more debt; and through loan covenants and monitoring specified prohibited types of behaviour.  

The exponential growth in CDSs shifted the externalities in a way that likely contributed to market destabilization. First, the disconnection between economic interest and residual control rights can create new incentives, in that originating lenders may be less willing to expend the time and resources to complete due diligence in undertaking credit arrangements, as risk is laid off through CDSs or other derivatives. Hence the signalling to the market with the decision to lend is no longer reliable as a measure of the firm’s value.  

Second, in lending transactions, parties have frequently given up the negotiation of terms and conditions—including monitoring, restrictive covenants and default control rights—because they know that they will offset their own risk through structured financial products. When the firm begins to slide into financial distress, corporate stakeholders no longer share a common goal of maximizing firm value and constraining managerial slack because the originating lender has hedged its risk through its derivatives, as have multiple subsequent counterparties. Stakeholders that could previously rely on the governance role of banks

31. Sarra, supra note 9, at 8. Externalities occur when an economic activity causes an external benefit or cost to third party stakeholders that were not directly involved in the transaction.  
33. Sarra, supra note 9, at 9.  
34. Id.
can no longer do so; yet given the diverse nature of their interests, information asymmetries, and collective action problems, they are unlikely to be able to fill this governance gap.\textsuperscript{35}

Multiplied many times through multiple and complex CDSs, previous positive externalities are lost and new negative externalities are created, creating more systemic risks across the market. The signalling through exit or other creditor reactions to the debtor's decisions is diminished because banks and other significant lenders may be fully hedged. Yet that fact is not transparent to other stakeholders, who may still look for such signalling. Given the global nature of credit derivatives, the externalities may create systemic problems that require more broad-based intervention than merely improving disclosure.

Governance issues may arise with the settlement of CDSs after a credit event. Where there are multiple CDSs with respect to a reference entity, physical settlement can create cascading swaps. The lending institution with which the debtor company had an ongoing credit relationship is no longer involved, and there are multiple new intermediaries and counterparties as CDSs settle. The company may not even appreciate it is a reference entity prior to the credit event occurring. Cascading swaps means multiple rapid changes to who holds a claim, making it difficult for a debtor company to establish who has a claim, or to garner the requisite support for a viable business restructuring plan under Chapter 11 of the U.S. Bankruptcy Code, or similar insolvency restructuring legislation.

For cash-settled CDSs, unlike insurance, no title to claim passes and the protection seller receives no right of subrogation. A creditor of a company that holds a cash-settled CDS has legal claim to the value of the assets of the financially distressed company, with little or no financial exposure. A senior secured creditor can have a powerful vote in a restructuring proceeding, yet has no economic risk remaining in the company. A debtor company and other creditors have no knowledge that the creditor has fully hedged its economic risk. The creditor may have little incentive to engage in constructive negotiations. If it has over-coverage and a negative economic interest, it may materially benefit if the company fails.

III. THE SEC AND REGULATORY GAPS

Globally, there has been a lack of regulatory oversight over CDSs. Either such products are part of the exempt market under securities or
financial services legislation, or there is not jurisdiction to oversee the CDS market. In the United States, the SEC’s mandate is to advance investor confidence in capital markets by providing investors with reliable information; to maintain fair, orderly, and efficient securities markets; and to enforce regulatory requirements. The SEC’s role in the OTC CDS market, however, was limited to enforcing antifraud prohibitions under securities laws. The “lack of clear regulatory authority” over the CDS market has hindered the SEC’s ability to monitor how the market functions or ensure “basic standards of fairness.” Current U.S. statutes significantly restrict financial regulators’ ability to obtain reporting in the CDS market to identify suspicious trading patterns or better understand systemic risks.

The U.S. regulatory gap was not just the result of domestic politics or fragmented regulation, but rather, was at least in part the result of a powerful and effective political lobbying by the industry’s organization, the ISDA, to exclude derivative products from regulatory oversight. Information asymmetries and collective action problems have prevented other market participants, such as companies or investors that may be affected by the agency problems arising from CDSs, from offering an alternative vision to Congress for regulatory oversight of CDSs.

Prior to the current market turmoil, the SEC had jurisdiction over the “safety and soundness” of U.S. investment banks. Yet its oversight consisted largely of an ineffective voluntary compliance program, which even former SEC Chair Christopher Cox admitted had been a failure. The SEC did not regulate the derivatives activities of U.S. investment banks, except the antifraud provisions.

The SEC operates on the principle of protection of individual well-being through investor protection. It has observed that any system of


39. Mary Schapiro, Chair, U.S. Sec. & Exch. Comm’n, Address to the Investment Company
regulation should facilitate fair and efficient financial markets through a strong and steady regulatory hand, while accommodating lively competition for capital. The SEC has also observed that any regulatory reform must promote and preserve public trust in U.S. financial markets. Arguably, the SEC's potential role in the CDS market includes transparency initiatives, regulatory oversight, rigorous enforcement, and encouraging new governance norms.

A. Transparency

The SEC has stated that a significant objective is to improve the transparency and integrity of the CDS market. It has sent letters to the public companies that it currently regulates regarding better disclosure of valuation and how credit risk is incorporated; disclosure of how counterparty credit risk affects valuation of derivative assets; and how the ability to collect on derivative assets will impact financial statement.\(^\text{40}\)

The SEC is also advocating legislation to create a mandatory system of recordkeeping and reporting of all CDS trades to aid in fraud detection. It would require trade and position reporting by dealers in OTC CDSs to increase transparency and improve pricing. The SEC has considered requiring position reporting from market participants with significant positions, to provide information that regulators need to uncover manipulation and monitor risk. The proposed legislation also specifies that the SEC and CFTC be given authority to issue new antifraud rules. The SEC has supported calls for a central counterparty clearing service (CCP) to enhance disclosure, as discussed in the next Part.

The SEC has proposed reforms to address the lack of a comprehensive procedure for rating derivatives; the proposal includes transparency measures.\(^\text{41}\) The reforms would regulate conflicts of interest, disclosures, internal policies, and business practices. The SEC has proposed differentiating ratings symbols for structured products. It has also specified that it has a public education role for credit ratings and the need for investors to make independent risk assessments.


40. Eighty percent of CDSs traded globally are currently confirmed through Deriv/SERV, but such confirmations are optional, and the platform does not serve complex CDS products, which are unregulated, with the SEC having no access to information stored. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 93 SEC Docket 1266 (June 16, 2008).

41. Id.
The U.S. government needs to make normative decisions regarding the scope and extent of any new regulation of the CDS market. The SEC has taken a number of actions in response to the financial market problems, including acting on concerns that counterparties are unable to meet their obligations under CDSs. In addition to the potential systemic risks that CDSs pose to financial stability, the SEC has expressed concern about operational risks, as well as risks relating to manipulation and fraud, and regulatory arbitrage risks in the market.

The President's Working Group on Financial Markets reported that implementing the central counterparty services for CDSs was a top priority, recommending that public reporting of prices, trading volumes, and aggregate open interest should be required to increase market transparency. The SEC worked closely with the Board of Governors


of the Federal Reserve System (FRB) and the Commodity Futures Trading Commission (CFTC) to create a mechanism to recognize central counterparties for the CDS market and establish organized markets for CDSs to reduce systemic and operational risks. To advance this objective, the SEC, FRB, and CFTC signed a Memorandum of Understanding in November 2008 that established a framework for consultation and information sharing on issues related to central counterparties for credit default swaps, as part of its efforts to enhance transparency in the CDS market, stabilize financial markets by reducing counterparty risk, and promote efficiency in the CDS market.

The SEC adopted interim final temporary rules providing exemptions under the Securities Act of 1933, Securities Exchange Act of 1934, and Trust Indenture Act of 1939 for certain CDSs to facilitate one or more central counterparties for those swaps.\textsuperscript{44} The interim final temporary rules define and exempt “eligible credit default swaps,” other than the Section 17(a) antifraud provisions. They are also exempted from Exchange Act registration requirements and from the provisions of the Trust Indenture Act, provided certain conditions are met.\textsuperscript{45} An “eligible credit default swap” is defined as a bilateral executory derivative contract, where a buyer makes payments to the seller in return for a payout if there is a default or other credit event involving identified obligations or entities; and which specifies obligations, terms, notional amounts on which payment obligations are calculated, credit-related events that trigger a settlement obligation, and deliverables on settlement.\textsuperscript{46}


\textsuperscript{45} The rules also define as a “qualified purchaser”:

any eligible contract participant (as defined in Section 1a(12) of the Commodity Exchange Act (7 U.S.C. 1a(12)) as in effect on the date of adoption of this section, other than a person who is an eligible contract participant under Section 1(a)(12)(C) of the Commodity Exchange Act) that has been sold an eligible credit default swap (as defined in Rule 239T of this Act) in reliance on Rule 239T of this Act.

17 C.F.R. § 230.146(c) (2009).

\textsuperscript{46} An “eligible credit default swap” is defined as a:

bilateral executory derivative contract not subject to individual negotiation:

(1) in which a buyer makes payments to the seller and, in return, receives a payout if there is a default or other credit event involving identified obligation(s) or identified entity(ies) within a certain time; and

(2) The agreement for which includes the:

(i) Specification of the identified obligation or obligor; or, in the case of an identified group or index thereof, all of the identified obligations or obligors comprising any such group or index;
These rules also define "qualified purchaser" for purposes of the covered securities provisions of Section 18 of the Securities Act. The SEC has observed that CCPs have the potential to reduce some systemic risk by netting all gains and losses across different instruments; through uniform margining and robust controls over its exposures, including specific controls on marketwide exposures; and will assist in preventing a single market participant failure from destabilizing markets; and assist trades being cleared in timely fashion. A central counterparty can enhance the stability of the credit derivatives market by collecting margin and guaranty fund deposits from each clearing member, to mitigate the impact of a potential default by one or more clearing members. Conditions for exemptions to operate CCPs include keeping an audit trail of orders and transactions effects; recordkeeping; reporting to SEC quarterly on the total dollar value of transactions, unit volume and notional amount executed, and list of subscribers; confidentiality requirements for clients; and SEC access to conduct on-site inspections. The interim final temporary rules are effective January 22, 2009 through November 30, 2010.

A CCP novates bilateral trades, which would result in the CCP entering separate contractual arrangements with both counterparties to a CDS, becoming buyer to one and seller to the other. "Novation" is a "process through which the original obligation between a buyer and seller is discharged through the substitution of the CCP as seller to buyer

(ii) Term of the agreement;
(iii) Notional amount upon which payment obligations are calculated;
(iv) Credit-related events that trigger a settlement obligation; and
(v) Obligations to be delivered if there is a credit-related event or, if it is a cash settlement, the obligations whose value is to be used to determine the amount of settlement obligation under the eligible credit default swap.

47. See supra note 39.
49. The Securities Act exemption:
also provides that eligible CDS that are or will be issued or cleared by a Registered or Exempt CCP and are entered into with an issuer of a security, or an underwriter or affiliate of such issuer, if such security is delivered in settlement or whose value is used to determine the amount of the settlement obligation, will be considered an offer and sale of such security at that time. . . . The Securities Act exemption is limited to offers and sales to eligible contract participants.

Temporary Exemptions for Eligible Credit Default Swaps, 74 Fed. Reg. at 3,972.

The amendment to "Securities Act Rule 146 applies only to eligible contract participants that have been sold eligible CDSs in reliance on the new interim final temporary exemption in Securities Act Rule 239T." Id.
and buyer to seller, creating two new contracts."  

Under a CCP arrangement, both parties entering a CDS would novate their trades to the CCP, and the CCP would stand in as the counterparty to all parties of the CDS it clears. As a result of the novation process, the counterparty risk of a CDS is effectively concentrated in the CCP. In companion actions to the interim final temporary rules, the SEC temporarily exempted a clearing agency acting as a CCP from the requirement to register as a clearing agency under Section 17A of the Exchange Act, as well as certain eligible contract participants and others from certain Exchange Act requirements with respect to certain CDSs. The rules’ exemptive orders are intended to facilitate the operation of CCPs that will clear and settle CDS transactions while enabling the SEC to oversee the CDS market.  

“The conditions and representations in the companion exemptive orders and exemptions require that information be available about the terms of the CDS, the creditworthiness of the CCP or any guarantor, and the clearing and settlement process for the CDS.” The “conditions require that financial information about the reference entity, the issuer of the reference security, or the reference security be publicly available.”  

Absent an exemption:  

the offer and sale of eligible CDS that are or will be issued or cleared by a Registered or Exempt CCP would have to be registered under the Securities Act, the eligible CDS that are or have been issued or cleared by a Registered or Exempt CCP would have to be registered as a class under the Exchange Act, and the provisions of the Trust Indenture Act would apply.  

A Registered or Exempt CCP issuing or clearing eligible CDSs “will benefit from the temporary exemptions because it will not have to file registration statements ... covering the offer and sale of the eligible CDS. ... [The] cost of filing a registration statement covering the  

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50. COMM. ON PAYMENT AND SETTLEMENT SYS., BANK FOR INT’L SETTLEMENTS, RECOMMENDATIONS FOR CENTRAL COUNTERPARTIES 66 (2004). CDS agreements generally are negotiated and entered into bilaterally, but both parties can agree that one party may novate the agreement and substitute another party to take responsibility for performance, by acting as the counterparty.  

51. See Temporary Exemptions for Eligible Credit Default Swaps, 74 Fed. Reg. at 3,968. It also temporarily exempted “any exchange that affects transactions in certain CDS from the requirements under Sections 5 and 6 of the Exchange Act to register as a national securities exchange, and any broker or dealer that effects transactions on an exchange in certain CDS from the requirements of Section 5 of the Exchange Act.” Id. (footnote omitted).  

52. Id. at 3,973.  

53. Id.  

54. Id.
eligible CDS would be lessened further as the information regarding the CCP already would be prepared."

The SEC suggests that approval of the exemptions will promote stability in financial markets by reducing the counterparty risks posed by the default or financial distress of a major market participant. The exemptions will help enhance competition in the market for the central clearing of CDSs and ensure greater protection for investors through SEC regulatory oversight of the central counterparty—providing timely centralized clearing and allowing the SEC time to evaluate whether registrations or permanent exemptions should be granted in the future. The SEC has concluded that the operation of CCPs in accordance with its exemptions will improve the efficiency and effectiveness of the CDS market, increase transparency of exposures to particular reference entities, increase available information about reference entities, and allow the SEC to take additional action necessary to protect investors.

The conditions that apply to the exemptions are designed to provide that key investor protections and important elements of Commission oversight apply, while taking into account that applying all the particulars of the securities laws could have the unintended consequence of deterring the prompt establishment and use of a central counterparty. The SEC has suggested that well-regulated central counterparties should reduce the potential for disruption in financial markets attributable to CDSs, and promote operational efficiencies.

The introduction of CCP is at a nascent stage. In December 2008, the SEC approved temporary exemptions allowing LCH.Clearnet, Ltd., to operate as a central counterparty for credit default swaps. In March 2009, the SEC approved conditional exemptions that allow Intercontinental Exchange (ICE) US Trust LLC to operate as a CCP for cleared credit default swaps.

55. Id. "The availability of exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act also would mean that CCPs would not incur the costs of preparing disclosure documents describing eligible CDS and from preparing indentures and arranging for the services of a trustee." Id.


57. Id. The SEC’s authority over the OTC market for CDSs is limited to swap agreements; Section 2A of the Securities Act and Section 3A of the Exchange Act limit the SEC’s authority over “swap agreements” as defined in Section 206A of the Gramm-Leach-Bliley Act, Rules at 7.

clearing credit default swaps.\textsuperscript{59} ICE Trust was first to the market in the United States.

ICE Trust CCP began processing and clearing CDSs in March 2009. Each member of the ICE clearinghouse contributed $20 million to the ICE Trust guaranty fund, which will continue in scale with the transfer of CDS positions to the CCP.\textsuperscript{60} ICE contributed an initial $10 million toward establishing the fund and over a two-year period will increase the guaranty fund commitment to $100 million.\textsuperscript{61} ICE describes itself as a limited purpose bank that serves as a CDS central clearing facility, subject to regulatory and supervisory requirements of the Federal Reserve System and the New York State Banking Department. In addition, it notes that both the SEC and the CFTC may request review of ICE Trust transaction data from its primary regulator, the Federal Reserve.\textsuperscript{62} ICE Trust serves as a clearing house for all North American CDS indices, initially focusing on the most active indices.\textsuperscript{63} Clearing members to date are Bank of America/Merrill Lynch, Barclays Capital, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Morgan Stanley, HSBC Bank USA, and UBS.\textsuperscript{64} Under ICE Trust's


\textsuperscript{60} ICE TRUST, supra note 20.

\textsuperscript{61} DerivSource, ICE Announces Addition of HSBC as Twelfth CDS Clearing Member, http://derivsource.com/articles/ice-announces-addition-hsbc-twelfth-cds-clearing-member (May 27, 2009). NYSE Euronext announced:

\begin{quote}
that NYSE Liffe, its international derivatives business, has received approval in principle from the Financial Services Authority (FSA) to launch NYSE Liffe Clearing, its central clearing counterparty for its London derivatives market . . . due to begin operating on 27 July 2009, subject to a period of review by members of the proposed documentation (i.e. amendments to Rules and Clearing Arrangements) which incorporates the new arrangements and the finalisation of tax relief with HM Treasury.
\end{quote}

Press Release, NYSE Euronext, supra note 59.

\textsuperscript{62} ICE, Clearing, https://www.theice.com/ice_trust_jhtml (last visited Feb. 28, 2010).

\textsuperscript{63} Id. ICE Clear Europe in the U.K. is developing the capability of offering central counterparty clearing services for the European CDS market.

\textsuperscript{64} ICE TRUST, supra note 20. ICE Trust has:

\begin{quote}
structured its clearing house to operate with the asset servicing capabilities of The Depository Trust & Clearing Corporation’s (DTCC) DerivSERV, a service that has
\end{quote}
clearing rules, each bilateral CDS contract between two clearing members that is submitted to ICE Trust for clearing will be novated. As part of this process, the submitted contract is replaced by two superseding CDS contracts between each of the original parties to the submitted transaction and ICE Trust. Under these new contracts, ICE Trust will act as "protection buyer" to the original "protection seller" and as "protection seller" to the original "protection buyer."

The Federal Reserve has described the ICE CCP as follows in its regulatory approval decision:

ICE Trust is being organized to reduce the risk associated with the trading and settlement of CDS transactions. . . . CCPs interpose themselves between counterparties to financial contracts, becoming the buyer to the seller of the contract and the seller to the contract’s buyer. In the absence of a CCP, each market participant bears the risk, known as counterparty credit risk, that one or more of its counterparties will default. By interposing itself between participants and thereby assuming counterparty credit risk, a CCP enables market participants to accept the best bids and offers without concern that a counterparty may default.

By assuming counterparty credit risk and enforcing participation standards and margin requirements, CCPs also can help diminish systemic risk in market settlement activities. In addition, establishment of a CCP can lower systemic risk by instituting procedures for the orderly close out of the positions of any participant who defaults and by mutualizing the cost of the close-out process.

. . .

To limit the risk of default by participants, ICE Trust proposes to establish strong and objective participant eligibility requirements. For example, only a firm with a net worth of $5 billion or more and a credit rating of "A" or better may become a participant. Among other criteria, each prospective participant also would be required to demonstrate that it has systems, management, and risk-management expertise with respect to CDS transactions. . . . The establishment of ICE Trust as a CCP for CDS contracts is expected to minimize the impact on financial markets of a failure by a single participant by collateralizing counterparty risk exposures through the standardized application of margin and guaranty fund requirements, by reducing exposures through the netting of CDS transactions on a multilateral basis, and by standardizing and centrally managing the close out of a defaulting participant’s positions with the CCP.85

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proven extremely successful in significantly reducing the post-trade operational backlogs associated with the CDS market. ICE Trust will utilize DTCC’s Deriv/SERV matching and confirmation service which is already used today by the industry to document cleared CDS transactions.

The Federal Reserve generally requires disclosure of CDSs in both the trading and the banking book of its regulated entities, reporting on single name and multiname CDSs, such as portfolio or basket CDSs or CDS indices; and multiamie CDSs that are "tranchéd" credit default swaps. Being regulated by the Federal Reserve likely pulls the ICE under this regulatory framework.

The Federal Reserve has taken oversight jurisdiction for the first CCP, leaving an uncertain role for the SEC. It can monitor the conditions under which it granted an exemption, although the public representations by the SEC and ICE CCP seem to differ as to the amount of disclosure that will be made to the SEC. Absent transparency, the SEC will have difficulty exercising any oversight powers. This issue is particularly important with respect to its investor protection mandate, as the CCP is likely to have a very significant role in the CDS market. Since its launch two months ago, ICE Trust CCP has cleared 7,478 transactions, totaling $646 billion of notional value of CDX indexes.

SEC Chair Mary Schapiro has argued that there should be a government entity whose responsibilities include monitoring the financial system for system-wide risk, and is equipped with the tools to forestall emergencies. Schapiro supports a hybrid approach, with a single regulator for systemically significant firms, coupled with a systemic risk council to provide macro-prudential risk oversight. This

For ICE Trust, as for many CCPs, these resources include margin collateral posted by participants based on the value and risk associated with their open positions and participants' contributions to a guaranty fund. The Board expects ICE Trust at all times to maintain financial resources commensurate with the level and nature of the risks to which it is exposed.

If a participant defaults, ICE Trust would draw on margin collateral posted by the participant. If the margin collateral is insufficient, ICE Trust would then look to the defaulting participant's guaranty fund contribution. Should the defaulting participant's margin collateral and guaranty fund contribution be insufficient to cover any losses on the defaulted obligations, ICE Trust would be authorized to use, as needed, other participants' guaranty fund contributions to satisfy any remaining obligations of the defaulting party. If the guaranty fund in total is inadequate to cover losses on the defaulted obligations, ICE Trust would have the ability to assess additional guaranty fund contributions on nondefaulting participants.

Id. at 5.


67. DerivSource, supra note 61.

68. Schapiro, supra note 37.

69. Id. (as proposed by FDIC Chair Sheila Bair).
entity should have access, through the functional regulators, to sufficient
information to provide a view of the financial system as a whole; and it
should have sufficient power to direct prudential regulators, strengthen
capital requirements, and direct regulated institutions to reduce leverage
as circumstances require.  

C. Enforcement

In the past year, the SEC has taken steps to streamline its enforcement
procedures, hired new expertise regarding CDSs, and upgraded its
technological capabilities to better detect fraud. It has also expanded
its investigations into possible market manipulation by financial
institutions, requiring disclosure of CDS positions. This initiative,
however, has been difficult because of lack of uniform recordkeeping
and reporting, and the SEC’s limited oversight role.

The SEC is nonetheless taking action against market misconduct.
The SEC filed the first civil action regarding CDSs in the U.S. District
Court for the Southern District of New York in May 2009. The SEC has
alleged that Renato Negrin, a former portfolio manager at hedge fund
investment adviser Millennium Partners, L.P., and Jon-Paul Rorech, a
salesman at Deutsche Bank Securities, Inc., engaged in insider trading in
the credit default swaps of VNU N.V., an international holding company
in the media sector. The complaint alleges that Rorech learned
information from Deutsche Bank investment bankers about a change to
the proposed VNU bond offering that was expected to increase the price
of the CDSs on VNU bonds. Deutsche Bank was the lead underwriter
for a proposed bond offering by VNU. According to the complaint,
Rorech allegedly illegally tipped Negrin about the contemplated change
to the bond structure, and Negrin then purchased CDSs on VNU for a
Millennium hedge fund. When news of the restructured bond offering
became public in late July 2006, the price of VNU CDSs substantially
increased, and Negrin closed Millennium’s VNU CDS position at a
profit of approximately $1.2 million. The SEC’s complaint charges
Negrin and Rorech with violations of the antifraud provisions of the
Securities Exchange Act of 1934 and seeks a judgment ordering them to
pay financial penalties and disgorging ill-gotten gains—plus
prejudgment interest.

70. Id.
71. Schapiro, supra note 37.
(“SEC Files First Credit Default Swap Insider Trading Case”).
73. Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Hedge Fund Manager and Bond
IV. A Good Start, But . . .

The SEC has made important changes to address the CDS market, limited as it has been by its regulatory authority. A critically important question is whether CDSs will be redefined to come under the regulatory purview of the SEC, a matter as yet undetermined in the United States.

All of the regulatory oversight options in the United States to date assume sophisticated market players, and thus limited oversight requirements. This view ignores the impact of CDSs on other markets and ordinary citizens. The approach also does not acknowledge that the CDS market is global but the regulatory framework is local, which creates cross-border regulatory challenges. ISDA auction based settlement mechanisms are helpful, but there are problems with access to accurate counterparty exposure data, and repeat players and industry insiders are the only participants in the policy debates regarding regulation. There is disconnection between the issues addressed to date, and governance issues with respect to CDSs; with a tension between financial services, corporate law, and bankruptcy regimes.

The SEC needs to determine what type of CDSs are not appropriate for exemption and the scope of required disclosures. The SEC should consider whether there is a need for more substantive transparency. For example, legislative amendments could require protection sellers to disclose material adverse risk to their financial health at time of sale or renewal of a CDS. Financial institutions developing new products could be required to disclose underlying material risks to counterparties. Credit rating and other entities that recommend investment could be required to meet a due diligence standard in examining and disclosing material adverse risk in products being sold in the public market. Effective remedies should be introduced for purchasers that suffer from the failure of individuals and entities recommending or rating derivatives to meet due diligence and disclosure obligations. Information asymmetries in the OTC CDS market should be reduced through disclosure requirements that are targeted and measured against potential outcomes.

Salesman in First Insider Trading Case Involving Credit Default Swaps (May 5, 2009). The SEC charged Renato Negrin, a former portfolio manager at hedge fund investment adviser Millennium Partners L.P., and Jon-Paul Rorech, a salesman at Deutsche Bank Securities Inc., with insider trading in credit default swaps of VNU N.V., an international holding company that owns Nielsen Media and other media businesses. The case was handled by the SEC Enforcement Division's Hedge Fund Working Group, which is investigating fraud and market manipulation by hedge fund investment advisers. Millennium has agreed to escrow the amount that the SEC is seeking as ill-gotten gains pending a final judgment in this case. The Commission's complaint charges violations of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.
The underlying principle is that there must be sufficient disclosure of material information to allow market participants to make informed choices about CDS investments. Protection buyers should be required to disclose, at the time of purchase, any material adverse risk in the reference entity that they are aware of, or ought reasonably to be aware of, so protection sellers can appropriately price the contract. Materiality in this respect could be based on a standard of whether the facts regarding adverse risk reasonably would be expected to have a significant effect on the protection seller's valuation or pricing of the derivative. Protection sellers should be required to disclose any material adverse risk to their financial health at the time of the sale and renewal of a derivative contract, and could have an ongoing disclosure requirement regarding material adverse change to their ability to settle the derivative at the point of a credit event occurring. This transparency would reduce the potential for unnecessary and unfair financial loss for market participants through greater transparency regarding material risk. It would require plain and timely disclosure of such information to retail and other purchasers as an investor protection measure.

Financial institutions and other parties that create new CDS products should be required to disclose underlying material risks to the derivatives to counterparties. Counterparties purchasing CDSs should have enforceable remedies for the failure of these entities and individuals to disclose material adverse risks at the point of sale of the derivatives. Such remedies would increase the transparency of risks associated with new products as they develop, allowing for market innovation while trying to ensure that there is sufficient information in the market to assess and price risk. They would also ensure that those making the products available are providing a type of indemnification with respect to the product, in terms of assurances that the material adverse risks are known by the counterparties at the time of sale.74

Restricting the supply of derivatives products will relocate the products to other jurisdictions, given their high degree of mobility. Increased transparency is one necessary measure; however, enhancing disclosure alone does not ensure that purchasers can properly interpret the information, nor does it assist in offering remedies for misconduct. One way to compensate for potential negative externalities is to set a price for participation in the market. For example, one could tax credit derivatives on a per transaction basis.75 A small amount on each transaction could be placed in a central trust fund in the domestic

74. For a discussion of these recommendations, see Sarra, supra note 9.
75. Id. at 9.
jurisdiction in which the credit derivative is being purchased. That fund would be available to counterparties that had been unfairly harmed by failure to disclose or other misconduct by market participants; or the fund could be restricted to payments during financial crises. Not unlike deposit insurance funds, pension guarantee funds, or securities law “fair funds,” the fund would be available, up to some specified cap, to cushion such losses. The fund could possibly be empowered to impose risk-based levies on the counterparties that cause the losses, in an attempt to partially recover when the counterparty is solvent. On insolvency, such a claim by the fund would be eligible for debt to equity conversion along with other creditors’ claims. Such a strategy would spread the cost of misconduct across parties most actively buying and selling CDSs and other derivatives, would allow cost recovery against specific counterparties in some cases, and would diminish the risk of unfair losses to end purchasers. Such a transaction-based fee, however, would have to be priced such that it was not merely the price of misconduct.

The SEC should also consider how mark-to-market accounting has influenced and been influenced by the credit derivatives market, and whether it should be adjusted to account for current financial uncertainty. Mark-to-market accounting requires that asset price shocks be reflected on balance sheets, creating their own shocks and raising the question of whether market prices appropriately reflect economic value or whether this approach fosters greater uncertainty for investors.

Credit rating and other entities that recommend investment in derivatives should meet a due diligence standard in examining and disclosing material adverse risk in the derivative products being sold in the public market. Credit rating agencies should be required to disclose

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76. *Id.* at 10.

77. Under current mark-to-market, some long-term investors face pressure to sell their CDSs because of short term funding requirements. The opacity of structured financial products has made them harder to value, thus negatively affecting secondary market liquidity. See Janis Sarra, *Restructuring of the Asset-Backed Commercial Paper Market in Canada, in Annual Review of Insolvency Law, 2008* (Janis Sarra ed. 2009). Essentially, by reflecting market moves, fair value accounting increases the volatility of reported earnings. Arguably, officers’ incentives to realize mark-to-market losses are also influenced by the extent to which their investors will reward or negatively sanction them for how they value downside risk.

all fees associated with a rating, as well as consulting fees received from
the bank or entity selling the derivatives. There should be effective
remedies for purchasers and other market participants from failure of
those individuals and entities recommending or rating derivatives to
meet due diligence and disclosure obligations. Such a move would
create appropriate incentives for credit rating agencies and others that
recommend investment in credit derivatives to undertake diligent
examination and assessment of products, including ascertaining and
disclosing material risk, and to reduce their conflicts of interest.

The SEC should consider several public policy questions in its efforts
to create CCPs. For example, is the appropriate approach to CCPs to
exempt securities, or draw them under the banking regulatory umbrella?
How will its regulatory intervention recognize the interconnected nature
of financial services markets and real economic activity? The SEC has a
potential role in crafting new oversight that could slow inappropriate
speculative aspects of the market and assist risk management. The CCP
system enables regulators to better monitor transactions that are effected
through the use of a central counterparty and arguably mitigate the
systemic risks created by OTC derivatives. The question is whether
there will be sufficient transparency to ensure systemic risks are
adequately monitored. The SEC has stated that it believes that eligible
CDS participants are sophisticated investors who do not require the
protections of registration under state securities laws; yet one remaining
question is how the activities of these investors may harm the markets
over which the SEC does have regulatory oversight.

The introduction of CCPs does not address the incentives that were
driving the market at the time of the failure; arguably, they continue to
support the speculative aspects of the market by facilitating the
transactions. While CCPs do address some aspects of systemic risk,
their entry into the market may have short circuited a broader normative
public policy discussion about the need for a speculative market on top
of the risk management benefits of the market, as well as discussion
about the ability of financial products markets to seriously undermine
real economic activity.

There is a need for development of a broad global consensus
regarding products that should be eligible for CCPs, as well as the
degree of oversight and remedies for failure to observe standards. One
objective should be reducing counterparty risk, particularly given the
ripple effects in the real economy from counterparty failure. In the
United Kingdom, financial authorities have called for more robust

79. Schapiro, supra note 37.
counterparty risk management, recommending that all OTC derivative trades, whether centrally cleared, should be subject to robust arrangements to mitigate counterparty risk. Increased standardization of products would help ensure that parties understand derivatives products they are purchasing and would assist greatly in the development of clearing and auction activities, likely reducing operational risk. Standardization should extend to products that are bought and sold at significant volumes, whether or not they can be cleared through a CCP. Standardization, however, requires a shared global understanding of terms of contracts, so that regulators can appropriately monitor and enforce, and so that parties have certainty in their remedies wherever the derivative settles. The SEC could play a leadership role in building global consensus.

The SEC may also have a role in encouraging best practices standards for CDS transactions, through collaboration between regulators and market participants, including with respect to counterparty credit risk management, oversight, liquidity management, and netting. It may reduce counterparty risk, increase transparency in the market, and move towards creation of shared definitions of derivatives terms and shared standards and overarching principles. A hybrid of state and market driven strategies may be most effective. The market is able to more quickly adapt standards and measurement of risk to new product developments, but industry-standard setting alone is insufficient, and in the future may create self-serving standards. Current initiatives by industry participants could be enhanced by participation of regulatory authorities and investor protection organizations or other NGOs, to ensure public interest concerns are included in new standards.

Regulators should consider requiring public disclosure of “no economic interest at risk” derivatives and prohibiting actions by these derivatives holders that lead to default events, to address the moral hazard of financial products imperilling the real economy. This recommendation would reduce incentives for those holding derivatives products to engage in actions that precipitate credit events where they have no economic interest at risk. 80 Many insurance statutes require the insured have at least a factual expectation of loss if the object of the insurance suffers pecuniary damage, loss, or destruction—and the factual expectation requires a lawful or substantial economic interest in the preservation of the insured property. The same approach should be considered for CDSs in terms of requiring that a creditor that has hedged its claims through a CDS discloses the real quantum and nature of its

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80. Sarra, supra note 9, at 12.
remaining economic interest, if any, before it has decision or control rights in proceedings involving the reference entity.

It is also necessary to engage globally and align strategies with other jurisdictions to the extent possible. The Volcker 2009 report urged establishing “coordinated efforts to greatly reduce the growth and size of outstanding contracts through bilateral compression agreements” and provide a consistent international regulatory framework to share information and enter appropriate cooperative arrangements with authorities of other countries responsible for overseeing activities.81

The European Commission’s High Level Expert Group on Financial Supervision, chaired by Jacques de Larosière, concluded in February 2009 that there is a need to take a wide look at the functioning of derivative markets, finding that the simplification and standardization of most OTC derivatives and the development of appropriate risk-mitigation techniques, plus transparency measures, could go a long way toward restoring trust in the functioning of CDS markets.82 The de Larosière Committee determined that in the short term, an important goal should be to reduce the counterparty risks that exist in the system by creating in the EU of at least one well-capitalized central clearing house for OTC CDSs that would be simplified and standardized. This clearing house should be supervised by the Committee of European Securities Regulators, the relevant monetary authorities, and the European Central Bank. The Committee also reported that to restore confidence in securitized markets, it is important to require, at the international level, issuers of complex securities to retain a meaningful amount of the underlying risk on their books for the life of the instrument.83 The European Commission announced after the report that it will have specific legislative measures in place within the next two years. Major banks and brokers involved in the CDS industry in Europe have committed to using an EU-based central counterparty clearing for their trades by the end of 2010 agreeing to regulators’ requests to reduce risk.84 With a central clearing house, the counterparty


83. Id. at ¶ 95.

84. The letter’s signatories include Barclays Capital, Citigroup Global Markets, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley, and UBS, all members of the
would monitor the reliability of the parties and cover possible defaults through fees paid in advance by the traders. The EU may opt for mandatory use of CCPs as opposed to the voluntary model adopted in the United States to date. The SEC could acquire a better understanding of the public policy discussion in the EU and serve as a conduit to bring those considerations to the US public policy debate.

V. CONCLUSION

The public policy discussion on regulatory oversight of CDSs has just begun, yet the market for CCPs and other initiatives may overtake the debate. There is need to build greater international consensus on how to encourage the positive risk management aspects of derivatives, while slowing the speculative aspects of the market that create both transactional and systemic risk. The CDS market has few jurisdictional boundaries and regulators need to account for their ubiquitous, elusive, and opaque nature. The public interest aspects of CDSs require more consideration, as CDSs were a major contributing factor to the market failure, but there are, to date, few regulatory initiatives to address both the agency problems and externalities caused by their use. It is also time for more integrated thinking regarding the links between securities law, financial products, and corporate governance.

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ISDA, supported by the European Banking Federation (EBF), which represents both buyers and sellers in the derivatives market. Id.

85. Id. There is debate among EU member states about the scope and the location of the CCP. France is pushing for Paris, which would exclude the U.K. market, which is the most developed in Europe.