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Does the Dodd–Frank Wall Street Reform Act Rein In Credit Default Swaps? An EU Comparative Analysis

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I. INTRODUCTION

The global economic crisis brought credit default swaps (CDSs) out of the shadows of Wall Street and into the public consciousness.¹ As journalists and academics try to make sense of the economic downturn, CDSs figure prominently in their narratives.² Politicians and regulators have taken aim at these complex and, what are perceived

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1. See Sue Kirchhoff & Barbara Hagenbaugh, *Credit Market Has Pros Confused*, USA TODAY, Aug. 27, 2007, http://www.usatoday.com/money/economy/2007-08-27-econ-survey_N.htm (reporting the results of a 2007 survey of economists and professionals by the National Association for Business Economics, which found that "68% [of those surveyed] didn't have a handle on credit default swaps"); Gretchen Morgenson, *Arcane Market Is Next to Face Big Credit Test*, N.Y. TIMES, Feb. 17, 2008, <http://www.nytimes.com/2008/02/17/business/17swap.html> ("Few Americans have heard of credit default swaps But if the economy keeps slowing, credit default swaps, like subprime mortgages, may become a household term.").
 2. See Andrew Leonard, *The Credit Swap Credibility Gap*, SALON (Dec. 19, 2007), http://www.salon.com/technology/how_the_world_works/2007/12/19/junk_bond_insurers (calling credit default swaps "everybody's favorite credit derivative"); Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, <http://www.time.com/time/business/article/0,8599,1723152,00.html> ("Credit default swaps . . . could soon become the eye of the credit hurricane."); Heather Timmons, *The Year That Made Deal Makers Giddy*, N.Y. TIMES, Jan. 5, 2007, <http://www.nytimes.com/2007/01/05/business/05deal.html> (noting the role of credit default swaps in creating a record breaking number of mergers and acquisitions in 2006).

as, largely speculative financial plays, believing that this speculation was a major factor contributing to the global economic downturn.³ As a result, uncovered credit default swaps—and naked short selling—are frequently the target of regulators crafting prophylactic regulations designed to prevent future crises.⁴

The U.S. has taken the lead on financial reform, including regulation of CDSs. The Dodd–Frank Wall Street Reform and Consumer Protection Act,⁵ signed into law by President Obama on July 21, 2010,⁶ includes a nascent framework for comprehensive regulation of credit default swaps.⁷ This groundbreaking legislation not only significantly changes how CDSs and swaps generally are transacted and regulated, but it also mandates further study of the complex market forces responsible for the global economic downturn that are yet to be fully understood.⁸ This Article responds to the legislative call and examines if the Dodd–Frank legislation went far enough in regulating CDSs by examining alternative approaches for regulating CDSs being considered by our European counterparts.⁹

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3. See Huw Jones & Krista Hughes, *EU to Discuss Credit Default Swap Speculation, Watchdog Frets*, REUTERS, Mar. 8, 2010, available at <http://blogs.reuters.com/financial-regulatory-forum/2010/03/08/eu-to-discuss-credit-default-swap-speculation-watchdog-frets/> (reporting that EU finance ministers were meeting to consider how to “dampen speculation on sovereign credit default swap markets”); Dina Kyriakidou, *Greek PM Says Economic Crisis Confirmed Worst Fears*, REUTERS, Feb. 26, 2010, available at <http://www.reuters.com/article/idUSLDE61P0ZO20100226>. Speaking to the Hellenic Parliament, Greek Prime Minister George Papandreou summarized the government’s position: “There is only one dilemma: Will we let the country go bankrupt or will we react? Will we let the speculators strangle us, or will we take our fate in our own hands?” *Id.*
 4. See, e.g., Press Release, U.S. Congresswoman Maxine Waters, Congresswoman Waters Introduces Credit Default Swap Prohibition Act (July 10, 2009), available at <http://www.waters.house.gov/News/DocumentSingle.aspx?DocumentID=140685> (“Preventing all credit default swaps is essential to bringing stability to the market and preventing a similar crisis in the future. . . . Unless credit default swaps are banned entirely, I am concerned that the industry will find a way to loosen standards and widen exemptions for customized contracts and then we will be right back to where we are today, with capital markets hobbled and the financial system in need of additional government intervention.”).
 5. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
 6. See Jesse Lee, *President Obama Signs Wall Street Reform: “No Easy Task,”* WHITE HOUSE BLOG (July 21, 2010, 2:22 PM), <http://www.whitehouse.gov/blog/2010/07/21/president-obama-signs-wall-street-reform-no-easy-task>.
 7. See Dodd–Frank Wall Street Reform and Consumer Protection Act §§ 701–814, 124 Stat. at 1641–822.
 8. See *id.* § 719, 124 Stat. at 1654.
 9. The Article touches on naked short selling, which is also the subject of a Dodd–Frank Wall Street Reform and Consumer Protection Act mandated study. Although the focus of this Article is on regulation of CDSs, because naked short selling and uncovered CDSs are often equated, much of the analysis here is relevant to a discussion of naked short selling.

As part of the global financial marketplace, credit default swaps—with a global marketplace worth an estimated \$60 trillion¹⁰—have undoubtedly played a role in the recent financial crisis.¹¹ For instance, insurance giant AIG figured prominently in the collapse and subsequent government bailout, having written hundreds of billions in CDS protection.¹² When the economy took a dive as the sub-prime mortgage debacle kicked off, AIG was increasingly stretched thin as demands on its capital threatened to topple the company.¹³ In turn, a meltdown at AIG threatened to begin a domino collapse of banks and hedge funds, all dependent on AIG for protection in the event that the economy took a turn for the worse.¹⁴ The Federal Reserve (Fed) eventually stepped in, providing a \$182 billion bailout¹⁵ to keep the insurer afloat and stave off a broader economic collapse.¹⁶ The Fed's rescue effort sparked a public outrage,¹⁷ which soon turned from the recipient of the bailout to the financial instruments which precipitated its fall.¹⁸

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10. Bryan J. Orticelli, *Crisis Compounded by Constraint: How Regulatory Inadequacies Impaired the Fed's Bailout of Bear Stearns*, 42 CONN. L. REV. 647, 657 (2009).
 11. *See id.*; *Geithner Expects Bailout Program to End Soon*, N.Y. TIMES, Dec. 3, 2009, <http://www.nytimes.com/2009/12/03/business/economy/03derivatives.html>; Jon Hilsenrath et al., *Worst Crisis Since '30s, with No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, <http://online.wsj.com/article/SB122169431617549947.html>.
 12. *See* Serena Ng & Thomas Catan, *We Were 'Prudent': AIG Man at Center of Crisis*, WALL ST. J., July 1, 2010, <http://online.wsj.com/article/SB10001424052748703426004575338640175139822.html> (“In 2007 and 2008, banks called for collateral from AIG when the mortgage assets fell in value. Those collateral calls eventually overwhelmed the company and led to its near collapse.”).
 13. *See id.*
 14. *See* Lydie N.C. Pierre-Louis, *Hedge Fund Fraud and the Public Good*, 15 FORDHAM J. CORP. & FIN. L. 21, 90 (2009); Lilla Zuill & Kristina Cooke, *AIG Failure Would Still Be Disastrous for Global Markets*, REUTERS, Mar. 2, 2009, available at <http://uk.reuters.com/article/2009/03/02/uk-aig-bailout-sb-idUKTRE5211EW20090302>.
 15. John Martinez, *Getting Back the Public's Money: The Anti-Favoritism Norm in American Property Law*, 58 BUFF. L. REV. 619, 622–23 (2010).
 16. *See* Mark Labaton, *Swap Meet*, L.A. LAWYER, Oct. 2009, at 24, 27; Ng & Catan, *supra* note 12.
 17. *See* Sheryl Gay Stolberg, *Constituents Make Their Bailout Views Known*, N.Y. TIMES, Sept. 24, 2008, <http://www.nytimes.com/2008/09/25/business/25voices.html>.
 18. *See Duh, Hedge Funds Bought AIG Credit Default Swaps Too*, NAKED CAPITALISM (Mar. 17, 2009), <http://www.nakedcapitalism.com/2009/03/duh-hedge-funds-bought-aig-credit.html> (“If the public were to take offense at the idea of government money rewarding successful speculators, it might lead to restrictions on CDS writing in cases where the protection buyer did not own and continue to hold assets of the reference entity. One can only hope.”); *U.S. Sen. Grassley: The Financial Bailout*, IOWAPOLITICS.COM (Aug. 26, 2010), <http://www.iowapolitics.com/index.html?Article=205706> (decrying the diffusion of AIG bailout funds to CDS counterparties). In a Q&A style explanation of the bailout, U.S. Senator Charles Grassley of Iowa stated:

Interest in the role of CDSs in the financial crisis peaked again in early 2010, when the Greek government faced certain collapse,¹⁹ leading to an EU-IMF bailout.²⁰ Perhaps influenced by events in the U.S., the Greek government was quick to blame speculators for its financial woes—particularly speculators purchasing CDSs on Greek sovereign debt.²¹ In Athens’s view, CDSs intensified and hastened events leading to its financial instability and necessitating an EU bailout.²²

Some commentators and industry insiders claim that speculators, and innovative finance in general, are just scapegoats in the regulators’ quest to pin the blame for the financial catastrophe on a sector that is little understood and even distrusted by the public at large.²³ They say that governments seek to blame speculators at every financial crisis rather than take responsibility for their part in making the crisis.²⁴ Others claim that speculators in derivatives like CDSs are little more than gamblers, contributing nothing to the “real economy.”²⁵ These commentators link CDSs with activities—like gam-

So, the public bailed out AIG, and the money flowed through AIG to a few large banks, including Goldman Sachs. Now we know that the money kept flowing through Goldman to financial institutions and operations all over the world. It’s as if the New York Fed used AIG as a front man for the bailout of the other firms.

Id.

19. See Nelson D. Schwartz & Eric Dash, *Trades in Greek Debt Add to Country’s Financing Burden*, N.Y. TIMES, Feb. 24, 2010, <http://www.nytimes.com/2010/02/25/business/global/25swaps.html>; Jason Simpkins, *Credit Default Swaps Strike Again—This Time Driving Greece to the Brink of Default*, MONEY MORNING (Feb. 26, 2010), <http://moneymorning.com/2010/02/26/credit-default-swaps-7/>.
20. See Judy Dempsey & Jack Ewing, *Germany Approves Assistance for Greece*, N.Y. TIMES, May 3, 2010, <http://www.nytimes.com/2010/05/04/business/global/04ecb.html>.
21. See Kyriakidou, *supra* note 3.
22. See Schwartz & Dash, *supra* note 19.
23. See J. Scott Colesanti, *Laws, Sausages, and Bailouts: Testing the Populist View of the Causes of the Economic Crisis*, 4 BROOK. J. CORP. FIN. & COM. L. 175, 175 (2010) (“[T]he lingering economic crisis has drawn much attention to individual products and private sector villains thought to have caused the market meltdown.”).
24. See *id.* at 176 (listing the scapegoats of previous economic downturns); Nelson D. Schwartz, *Those Wall Street Gamblers Might Not Be Bad After All*, N.Y. TIMES, Mar. 20, 2010, <http://www.nytimes.com/2010/03/21/weekinreview/21schwartz.html>; *Blame the Speculators*, ECONOMIST BLOGS (June 8, 2010, 17:24), http://www.economist.com/blogs/freexchange/2010/06/capital_controls.
25. See Jean-Claude Trichet, President, European Cent. Bank, Lecture at the Universidade Nova de Lisboa: What Role for Finance? (May 6, 2010), available at <http://www.ecb.int/press/key/date/2010/html/sp100506.en.html> (arguing that, when decoupled from the real economy, finance introduces a moral hazard into the economy that incentivizes market manipulation). In addition to incentivizing fraudulent market manipulation, uncovered CDS transactions introduce market distortion by directly and inappropriately depressing the price of the underlying assets. See *id.*

bling—that carry a degree of social stigma,²⁶ and they associate CDSs with fraudulent investment practices like Ponzi schemes.²⁷ Beyond simple name calling, speculators are accused of distorting the underlying market and even of using CDSs to manipulate the market to their profit by taking steps to sink companies and governments.²⁸

Responding to these losses and public outrage over “Wall Street [e]xcesses,”²⁹ numerous proposals to regulate CDSs have emerged. A theme running through much of this commentary is the analogy between CDSs and insurance policies.³⁰ Like a casualty or life insurance policy, a CDS makes a payout to its purchaser on the occurrence of a loss event.³¹ In the case of a life insurance policy, the loss event is the death of the insured.³² Under a CDS contract, the loss event—called a “credit event”—is generally a company or government’s de-

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26. See Nicholas Varchaver & Katie Benner, *The \$55 Trillion Question*, FORTUNE (Sep. 30, 2008, 12:28 PM), http://money.cnn.com/2008/09/30/magazines/fortune/varchaver_derivatives_short.fortune/index.htm (“[C]redit default swaps became the world’s largest casino.”); Press Release, U.S. Senator Bernie Sanders, Summary of the Wall Street Reform Bill (July 15, 2010), <http://sanders.senate.gov/newsroom/news/?id=d6acf243-839f-4c62-adc2-b2f0c0d189ab> (“[The Dodd–Frank Wall Street Reform and Consumer Protection Act] does not do enough to stop too big to fail banks from gambling trillions of dollars in risky derivatives and credit default swaps.”). According to Senator Sanders, credit default swaps “led to the \$182 billion bailout of AIG, the collapse of Lehman Brothers, the downfall of Bear Stearns and precipitated the worst financial crisis since the Great Depression.” *Id.*
 27. See, e.g., Mary Childs, *Credit-Default Swap Index in U.S. Increases on Economic Data, Greek Bonds*, BLOOMBERG (Oct. 27, 2010, 4:33 PM), <http://www.bloomberg.com/news/2010-10-27/credit-default-swaps-index-in-u-s-climbs-as-yields-on-greek-bonds-soar.html>.
 28. See Vikas Bajaj, *Joint U.S.–New York Inquiry Into Credit-Default Swaps*, N.Y. TIMES, Oct. 20, 2008, <http://www.nytimes.com/2008/10/20/business/20swaps.html> (discussing an investigation into whether credit default swaps were used to manipulate the price of shares in some banks during the crisis); Floyd Norris, *Out of the Shadows and Into the Harsh Light*, N.Y. TIMES, Sep. 26, 2008, <http://www.nytimes.com/2008/09/27/business/27charts.html> (quoting SEC Chairman Christopher Cox who stated that the CDS market is “ripe for fraud and manipulation”).
 29. Blake Allison, Letter to the Editor, *Invisible Hand Should Restrain Wall Street Excesses*, WALL ST. J., Feb. 14, 2009, http://online.wsj.com/article/NA_WSJ_PUB:SB123458359567687341.html.
 30. See Letter from the Nat’l Conference of Ins. Legislators to the Chair of the House–Senate Fin. Reform Conference Comm., Congressman Barney Frank (June 15, 2010), <http://www.ncoil.org/HomePage/2010/07/152010CDSLetter.pdf> (describing the National Conference of Insurance Legislators’ recently drafted Credit Default Insurance Model Legislation and suggesting that CDSs should be regulated as insurance).
 31. See MOORAD CHOUDHRY, THE CREDIT DEFAULT SWAP BASIS 2 (2006).
 32. See PAMELA PETERSON DRAKE & FRANK J. FABOZZI, THE BASICS OF FINANCE: AN INTRODUCTION TO FINANCIAL MARKETS, BUSINESS FINANCE, AND PORTFOLIO MANAGEMENT 47 (2010).

fault on its bond obligations.³³ Insurance provides an easy analog for credit derivatives like CDSs, and insurance provides ready infrastructure and a regulatory blueprint for CDS regulation.³⁴

This line of proposals suggests that, like an insurance policy, a CDS should not be issued without the purchaser having an insurable interest in the “property” insured by the policy—i.e. the CDS’s reference obligation. Imposition of an insurable interest requirement on CDSs would prohibit an investor from purchasing CDS protection unless the investor also owns an asset on which the CDS is written.³⁵

The analogy between insurance and CDSs has many proponents because the contracts are similar, in that both types of contracts protect the purchaser from risk, transferring it to another party.³⁶ However, we must examine the contractual difference between a traditional insurance policy and a CDS and the sphere of influence of each type of contract before accepting insurance regulation as a map for regulation of CDSs.

Supplementing the comparison between CDSs and insurance policies, CDSs are often condemned in the same breath as naked short selling,³⁷ which has been the subject of increasingly strict federal (and worldwide) regulation in the past decade.³⁸ Similar to insurance, naked short selling provides a ready analogue to credit derivatives like CDSs. Like the analogy with insurance, the analogy between CDSs and financial transactions such as short selling has a certain intuitive appeal and yields valuable insight into the problems presented by CDSs.

The U.S. legislative effort directed at CDSs has shifted away from an insurance based approach, focusing instead on increasing transparency in the CDS markets.³⁹ Although officials of the European

33. See ANDREW CHISHOLM, *DERIVATIVES DEMYSTIFIED: A STEP-BY-STEP GUIDE TO FORWARDS, FUTURES, SWAPS AND OPTIONS* 75 (2d ed. 2010); CHOUDHRY, *supra* note 31.

34. The New York State Insurance Department was poised to regulate CDSs as insurance products in 2008 but abruptly changed its stance. See discussion *infra* section VI.C.

35. See George Soros, Op-Ed., *One Way to Stop Bear Raids*, WALL ST. J., Mar. 24, 2009, http://online.wsj.com/article/NA_WSJ_PUB:SB123785310594719693.html.

36. See ROBERT EYLER, *MONEY AND BANKING: AN INTERNATIONAL TEXT* 59 (2009).

37. See, e.g., Wolfgang Münchau, Editorial, *Time to Outlaw Naked Credit Default Swaps*, FIN. TIMES, Feb. 28, 2010, <http://www.ft.com/cms/s/0/7b56f5b2-24a3-11df-8be0-00144feab49a.html> (arguing that naked credit default swaps are “purely speculative gamble[s]”).

38. See Short Sales, Exchange Act Release No. 50103, 69 Fed. Reg. 48008, 48009 n.10 (Aug. 6, 2004); Judy Dempsey & David Jolly, *Germany Acts Alone to Protect the Euro and Big Banks Against Speculators*, N.Y. TIMES, May 19, 2010, <http://www.nytimes.com/2010/05/20/business/global/20short.html>.

39. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 701–814, 124 Stat. 1376, 1644–1822 (2010).

Union have yet to finalize comprehensive financial reform, having issued only a limited set of proposed rules on naked short selling and uncovered CDSs at the time this Article went to press,⁴⁰ the proposed rules have developed under the paradigm of an insurance-based regulatory model.⁴¹

This Article examines the measured regulatory approach taken by the U.S. Government, which focuses on introducing transparency into the CDS market, and contrasts it with the insurance-based regulatory approach considered by the European Commission,⁴² EU member states,⁴³ and the State of New York.⁴⁴ This Article also concludes that an outright ban or the imposition of an insurable interest requirement on CDSs would be counterproductive to the intended policy objective. Finally, this Article calls for more enforced transparency regarding swap markets.

II. OVERVIEW OF CREDIT DEFAULT SWAPS

A. Introduction

A single-name credit default swap⁴⁵ (CDS) is a bilateral contract under which a protection seller promises to make good on the protection buyer's losses in the event that the entity (i.e., the reference entity) that issued the CDS's underlying bond defaults on its debt obligations prior to maturity of the CDS.⁴⁶ In exchange, the buyer promises to make a series of payments (i.e., premiums) to the protection seller.⁴⁷

A CDS's reference entity may be a bond issuing corporation or government.⁴⁸ Premiums are typically paid on a quarterly or annual basis.⁴⁹

40. *Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps*, COM (2010) 482 final (Sept. 9, 2010), available at http://ec.europa.eu/internal_market/securities/docs/short-selling/20100915_proposal_en.pdf [hereinafter EC Proposed Regulation].

41. See, e.g., *EU Parliament Votes to Ban CDS Speculation*, BLOOMBERG BUSINESSWEEK (Mar. 7, 2011, 3:06 PM), <http://www.businessweek.com/ap/financialnews/D9LQJLCG0.htm> (noting that a regulation approved by the European Parliament would prohibit investors from purchasing "insurance on government debt if they don't own the underlying bond").

42. See EC Proposed Regulation, *supra* note 40.

43. See Dempsey & Jolly, *supra* note 38.

44. See discussion *infra* section VI.C.

45. In addition to single-name CDSs, CDS indexes, multi-name CDSs, and more complex variations on the CDS exist.

46. CHOUDHRY, *supra* note 31, at 8–9.

47. See *id.* at 8.

48. *Id.* at 6.

49. *Id.* at 9.

Upon default, either physical or cash settlement of the CDS will take place.⁵⁰ In a physical settlement, the buyer delivers the reference assets to the seller, who makes the protection payoff, which is equal to the reference asset's par value.⁵¹ In a cash settlement, the protection payoff will be equal to the notional amount of the CDS less the market value of the reference assets after default.⁵² A CDS is similar to a term life insurance contract in that the protection seller (i.e., insurer) will not make a protection payoff to the protection purchaser (i.e., insured) unless a default event occurs.⁵³

Generally, a CDS's credit event will be the reference entity's bankruptcy, obligation acceleration, obligation default, failure to pay, repudiation of or moratorium on its debt, or restructuring.⁵⁴ However, the triggering "credit event" may also be another occurrence that is negotiated between the CDS parties. For example, AIG wrote CDSs on mortgage securities issued by Goldman Sachs.⁵⁵ Under some of those CDSs, AIG was required to make payments to Goldman if the value of the mortgage assets making up the security decreased in value by 4% or more.⁵⁶

In addition to provisions requiring a payout on a CDS if a credit event occurs, CDS contracts also frequently require the protection seller to collateralize its obligation under the contract.⁵⁷ Collateral may be required of a protection seller based on a decrease in the value of the CDS's reference assets or the protection seller's creditworthiness.⁵⁸

In addition to allowing purchasers to hedge against potential losses on debt obligations, CDSs also permit investors to trade in risk. An investor who believes that an entity is at risk for default may purchase protection on that reference entity's debt—even if the investor does not have an interest in the CDS's reference obligation.⁵⁹ Similarly, an investor who believes that a reference entity is stable and

50. *Id.*

51. See EUGENE F. BRIGHAM & JOEL F. HOUSTON, *FUNDAMENTALS OF FINANCIAL MANAGEMENT* 210 (11th ed. 2007). "Par value" refers to a bond's face value, which is typically the price at which the bond is sold on issuance. *Id.*

52. CHOUDHRY, *supra* note 31, at 22.

53. See *id.* at 22–23.

54. See Christian Weistoffer, *Credit Default Swaps: Heading Towards a More Stable System*, DEUTSCHE BANK RESEARCH (Dec. 21, 2009), http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000252032.pdf.

55. Gretchen Morgenson & Louise Story, *Testy Conflict with Goldman Helped Push A.I.G. to Edge*, N.Y. TIMES, Feb. 6, 2010, <http://www.nytimes.com/2010/02/07/business/07goldman.html>.

56. See *id.*

57. CHOUDHRY, *supra* note 31, at 69–71.

58. See *id.*

59. See JAN JOB DE VRIES ROBBÉ & PAUL U. ALI, *SECURITISATION OF DERIVATIVES AND ALTERNATIVE ASSET CLASSES: YEARBOOK 2005*, at 94–95 (2005).

unlikely to default on its debt may sell protection and receive a stream of fixed payments (i.e., premiums).⁶⁰ CDSs may also be used to create “synthetic bonds.”⁶¹ If, for example, an investor wants exposure to \$50 million in GE debt, but cannot locate \$50 million in GE bonds, the investor can mimic exposure to \$50 million in GE bonds by selling protection on GE.

B. Secondary Market for CDSs

After a CDS is written either counterparty may sell their rights and duties under the CDS on the secondary market.⁶² The secondary market for CDSs emerged because a CDS’s spread changes over time.⁶³ The spread on a particular CDS is determined at issuance, but events transpiring after issuance often affect the creditworthiness of the reference entity.⁶⁴ If the reference entity’s debt is riskier after issuance, later-issued CDSs will have a higher spread, resulting in higher premium payments compared with earlier issued CDSs.⁶⁵ This increases the value of the first CDS to protection purchasers, because premium payments on the earlier issued CDSs will be lower than those of later issued CDSs, and this decreases its value for protection sellers, who can get higher rates by issuing new CDSs.⁶⁶ In contrast, if conditions for the reference entity improve rather than deteriorate after issuance of a CDS, later-issued CDSs will have lower spreads, increasing the value of the first CDS for protection sellers and decreasing its value for protection purchasers who can enter a new CDS contract at a lower spread.⁶⁷

A protection seller who wants to divest himself of his rights and responsibilities under the CDS will sell his rights under the contract (i.e., the right to receive fixed premium payments over time) and transfer his duties under the contract (i.e., the duty to make a payout if a specified credit event occurs) to a third party purchaser.⁶⁸ Likewise, a protection purchasers who can sell his rights under the contract (i.e., the right to a payout under the CDS if a specified credit event occurs) and transfer his duties under the contract (i.e., the duty to make periodic premium payments) to a third party purchaser.⁶⁹

60. *Id.*

61. CHOUDHRY, *supra* note 31, at 59–60.

62. *See* MOORAD CHOUDHRY, AN INTRODUCTION TO CREDIT DERIVATIVES 63 (2004).

63. *See* CHOUDHRY, *supra* note 31, at 9–13.

64. *See id.*

65. *See id.*

66. *See id.* at 38–45.

67. *See id.*

68. *See id.* at 9–10.

69. *See id.*

The original parties to the CDS must agree to the transfer, substituting the parties through novation.⁷⁰

C. Options and CDSs—Leverage to Build or Bury

As mentioned earlier in this section, a CDS is similar to an insurance policy, resulting in a payout if a credit event (e.g., a reference entity default) occurs.⁷¹ A CDS can also be analogized to a stock option. A stock option gives the purchaser the right either to buy or sell a specified quantity of a security at a set price—the option's strike price.⁷² Like an option's strike price, a CDS's definition of "credit event" will determine whether the CDS is profitable for parties to the contract.

One of the appealing attributes of both CDSs and stock options is the leverage both afford to investors. Stock options leverage the parties' gains and losses by giving them virtual control over a significant number of shares without requiring the purchaser to own those shares.⁷³ Thus, for instance, an investor who purchases or sells 100 stock options effectively controls, and realizes profits or losses on, 100 shares of stock without purchasing or borrowing those shares. Similarly, a person who sells \$10 million in CDS protection on Corporation ABC will realize similar profits and losses and is exposed to approximately the same risk as a person who purchases \$10 million in Corporation ABC's bonds. If ABC does not default on its bond, the protection seller will have received premiums from the protection purchaser that are roughly the same as the interest payments paid to the person who purchased ABC bond. Likewise, if ABC defaults on its bond, the person who purchased the bonds outright and the person who sold CDS protection on ABC will realize roughly equivalent losses. Note that, although the protection seller is in roughly the same financial position as the purchaser of the bonds, the protection seller did not purchase the bonds and did not expend \$10 million to purchase the bond. Aside from any transaction costs and collateral requirements in the CDS contract, the protection seller is effectively exposed to \$10 million in ABC bonds without the bond purchaser's \$10 million capital expense.

CDSs and options thus function similarly, providing investors with significant leverage that can multiply profits and losses.⁷⁴ As we'll discuss in the next section, the leverage provided by CDSs played two

70. See JAN JOB DE VRIES ROBBÉ, *SECURITIZATION LAW AND PRACTICE: IN THE FACE OF THE CREDIT CRUNCH* 174 (2008).

71. CHOUDHRY, *supra* note 31, at 2, 66.

72. JOHN C. HULL, *OPTIONS, FUTURES AND OTHER DERIVATIVES* 5–6 (4th ed. 2000).

73. MICHAEL C. THOMSETT, *THE OPTIONS TRADING BODY OF KNOWLEDGE: THE DEFINITIVE SOURCE FOR INFORMATION ABOUT THE OPTIONS INDUSTRY* 33–34 (2010).

74. *Id.*

potential roles in the financial crisis. First, the leverage inherent in CDSs has been blamed for allowing speculators to manipulate the market for Greek sovereign debt, destroying Greece's ability to fund its government. Second, CDSs allowed AIG, a U.S. insurance company, to lever itself into an untenable financial position that unraveled as housing prices plummeted with the subprime mortgage crisis that erupted in 2007 and 2008.

III. THE ROLE OF CDSs IN THE AIG & GREEK CRISES

A. The Greek Debt Crisis and Bailout

In early 2010, a number of European governments—including Greece, Portugal, and Spain—began showing signs of imminent financial collapse.⁷⁵ With €300 billion in debt—a figure bigger than its entire gross domestic output—and deficits of 12.7%, Greece has occupied the spotlight from the beginning of the sovereign debt crisis.⁷⁶ Further, as the Greek crisis began to unfold in February 2010, net short positions—including short sales and CDSs—in Greek debt increased.⁷⁷ Speculators taking these short positions were blamed by the Greek government for exacerbating the Greek government's financial slide by decreasing investor confidence in Greek sovereign debt.⁷⁸

At the core of the Greek crisis is its national debt. The Greek government relies heavily on foreign borrowing to fund its extensive social programs.⁷⁹ When the global recession hit, tax revenues—already shallow because of rampant tax evasion—fell to new lows, forcing additional borrowing.⁸⁰ Investors, growing leery of Greece's financial stability, began demanding higher yields on government bonds, significantly increasing Greece's cost of borrowing.⁸¹ Yields on

75. See Landon Thomas Jr. & Nicholas Kulish, *I.M.F. Promises More Aid for Greece as European Crisis Grows*, N.Y. TIMES, Apr. 28, 2010, <http://www.nytimes.com/2010/04/29/business/global/29euro.html>.

76. See Rachel Donadio, *Greek Leader Offers Plan to Tackle Debt Crisis*, N.Y. TIMES, Dec. 14, 2009, <http://www.nytimes.com/2009/12/15/world/europe/15greece.html>.

77. See Peter Garnham et al., *Traders Make \$8bn Bet Against Euro*, FIN. TIMES, Feb. 8, 2010, <http://www.ft.com/cms/s/00330ba78-149f-11df-9ea1-00144feab49a.html>.

78. See Steven Erlanger & Matthew Saltmarsh, *Greek Debt Crisis Raises Doubts About the European Union*, N.Y. TIMES, May 7, 2010, <http://www.nytimes.com/2010/05/08/world/europe/08europe.html>.

79. See Landon Thomas Jr., *Patchwork Pension Plan Adds to Greek Debt Woes*, N.Y. TIMES, Mar. 11, 2010, <http://www.nytimes.com/2010/03/12/business/global/12pension.html>.

80. See Dan Roberts, *Greek Debt Crisis: How Did the Greek Economy Get Into Such a Mess?*, GUARDIAN.CO.UK (May 6, 2010), <http://www.guardian.co.uk/world/2010/may/06/greek-debt-crisis-economy>.

81. Wanfeng Zhou, *See Euro Falls Broadly as Greek Debt Worries Escalate*, REUTERS, Apr. 21, 2010, available at <http://www.reuters.com/article/2010/04/21/markets-forex-idUSN2119764420100421>.

two-year bonds rose as high as 38% at the end of April 2010, surpassing the interest rate on many consumer credit cards.⁸²

As Greece's cost of borrowing increased, its borrowing capacity diminished, threatening the Greek government's ability to repay its debts and fund its social programs.⁸³ When the Greek Parliament was forced to cut spending in March 2010, riots broke out in the capital.⁸⁴

The final component of the Greek debt crisis—forcing the EU to take immediate action to stave off collapse—was the April 2010 downgrading of Greek sovereign debt to junk status, the lowest credit rating in the Eurozone.⁸⁵ This downgrade not only increased Greece's cost of borrowing but also increased interest rates on its old debt and resulted in the cancelation of Greece's international overdraft facility.⁸⁶

When the situation became untenable, the European Union was forced to step in or face the collapse of one of its members. Because default by the Greeks would likely increase the cost of borrowing for other troubled European economies, the EU had little choice but to bail out Greece.⁸⁷ In the beginning of May 2010, the European Union, together with the International Monetary Fund, made a €110 billion loan to Greece to stave off its imminent collapse.⁸⁸ The EU-IMF loan package came with significant conditions, including deficit and spending limits, tax increases, and increased retirement age for Greeks.⁸⁹ On top of the EU-IMF loan package, the European Central Bank has

82. See *Prospects Daily: Concern Over Greek Debt Pushes CDS Spreads to New Record*, WORLD BANK BLOGS (June 24, 2010, 17:24), <http://blogs.worldbank.org/prospects/node/686>.

83. See Roberts, *supra* note 80.

84. See Dan Bilefsky, *Greek Parliament Passes Austerity Measures*, N.Y. TIMES, May 5, 2010, <http://www.nytimes.com/2010/05/07/world/europe/07greece.html>.

85. See Landon Thomas Jr., *Europeans Fear Greek Debt Crisis Will Spread*, N.Y. TIMES, Apr. 27, 2010, <http://www.nytimes.com/2010/04/28/business/global/28euro.html>.

86. See Roberts, *supra* note 80.

87. See Thomas, *supra* note 85.

88. Roberts, *supra* note 80. Greece has a long history of economic instability. In fact, Greece was forced to wait two years before it was permitted to adopt the Euro, because adoption of the Euro requires satisfaction of the criteria imposed by the Maastricht Treaty, which limit deficits, debt, and inflation. See Jack Ewing, *Estonia's Adoption of Euro Advances, Despite Concerns from Central Bank*, N.Y. TIMES, May 12, 2010, <http://www.nytimes.com/2010/05/13/business/global/13kroon.html>. Greece adopted the Euro in 2001—under false pretenses about the extent of its deficits—and is once again violating Eurozone rules with its deficit spending, national debt, and inflation. See *id.*

89. Roberts, *supra* note 80.

also embarked on its own Greek sovereign debt bailout, purchasing billions in Greek debt on the secondary market.⁹⁰

B. The Collapse and Bailout of AIG

AIG's downfall primarily resulted from the CDSs it wrote on subprime mortgage backed securities.⁹¹ These credit derivatives were sold by AIG's financial products unit, AIGFP.⁹² Founded in 1987, the financial products unit first specialized in complex derivatives like interest rate swaps.⁹³ The unit rose to prominence quickly, raking in hundreds of millions of dollars a year for AIG.⁹⁴

When Goldman Sachs, a U.S. investment bank, began issuing mortgage backed securities in the 1990s, AIGFP "insured" Goldman's financial products.⁹⁵ AIGFP wrote its first credit default swaps in 1998.⁹⁶ Thereafter, the financial products unit flourished, bringing in \$3.26 billion of revenue at its height.⁹⁷

The first step in AIG's downfall occurred in 2005 when accounting irregularities at the insurer were investigated by the state of New York, and AIG's credit rating was downgraded to AA from AAA.⁹⁸ Many AIG-issued CDSs included a provision requiring AIG to post additional collateral to secure its CDS obligations if its credit rating fell below its long-standing AAA rating.⁹⁹

The financial products unit's relationship with Goldman flourished for many years, but it began to suffer when subprime mortgage backed securities covered by AIG-issued CDSs started showing signs

90. Wolfgang Reuter, *German Central Bankers Suspect French Intrigue*, SPIEGEL ONLINE, May 31, 2010, <http://www.spiegel.de/international/europe/0,1518,697680,00.html>. At the time that this Article went to press the prospect of a second Greek bailout was being discussed by EU officials. See Charles Forelle, *Greek Woes Spur Tough Options*, WALL ST. J., May 13, 2011, <http://online.wsj.com/article/SB10001424052748704681904576319332030443232.html>.

91. See Hilsenrath et al., *supra* note 11.

92. See Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 27, 2008, <http://www.nytimes.com/2008/09/28/business/28melt.html>.

93. *Id.*

94. *Id.*

95. See Morgenson & Story, *supra* note 55.

96. *Id.*

97. Morgenson, *supra* note 92.

98. See Diane Brady & Marcia Vickers, *AIG: What Went Wrong*, BLOOMBERG BUSINESSWEEK, Apr. 11, 2005, at 32, 32, available at http://www.businessweek.com/magazine/content/05_15/63928042_m2011.htm; Lynnley Browning, *Questions About Earnings Manipulation Weigh on A.I.G.*, N.Y. TIMES, Mar. 16, 2005, <http://www.nytimes.com/2005/03/16/business/16place>.

99. See Robert O'Harrow Jr. & Brady Dennis, *Credit Rating Downgrade, Real Estate Collapse Crippled AIG*, L.A. TIMES, Jan. 2, 2009, <http://articles.latimes.com/2009/jan/02/business/fi-aig2>.

of distress.¹⁰⁰ AIG's relationship soured because Goldman had driven hard bargains with AIG when negotiating the terms of the CDSs, and AIG balked when Goldman sought to enforce its terms in mid-2007.¹⁰¹ CDSs issued to Goldman had a very low mark at which payments on the CDSs were required.¹⁰² Some of these CDSs paid out at 4%, when the standard mark at which payments would be made was 8%.¹⁰³ Goldman also insisted that its valuations, and not those of an independent third party, be used to determine when additional collateral was needed to secure AIG's potential liabilities to Goldman.¹⁰⁴

In addition to making poor deals when writing its CDSs, AIG also failed to hedge its CDS positions.¹⁰⁵ As discussed in the introduction, many CDS protection sellers balance their risk by purchasing equivalent protection.¹⁰⁶ When risks are balanced, default by the CDS's reference entity will result in a payout by the protection seller that is balanced by the payout it receives as protection purchaser on the balancing CDS.¹⁰⁷

AIG did not purchase protection to balance its risk in the CDSs it wrote.¹⁰⁸ As an insurance company, AIG treated the credit default swaps as if they were insurance policies.¹⁰⁹ With insurance business, the insurance company can generally depend on paying out on a predictable schedule.¹¹⁰ Barring a catastrophic natural disaster, only a small number of policies—whether property or life insurance—will require payment at any one time.¹¹¹ If premiums are calculated correctly, premiums paid to the insurance company will be greater than payouts made by the company.¹¹² In contrast, payouts on CDSs depend on the health of the greater economy.¹¹³ During a downturn in the economy, credit events triggering payout on CDSs are more likely to happen en masse.¹¹⁴

Because AIG wrote CDSs without purchasing corresponding protection, when the global recession took hold, the reference assets began defaulting, and AIG was faced with making \$440 billion in

100. See Morgenson & Story, *supra* note 55.

101. See *id.*

102. See *id.*

103. *Id.*

104. See *id.*

105. See Morgenson, *supra* note 92.

106. See discussion *supra* section II.A.

107. See discussion *supra* section II.A.

108. See Morgenson, *supra* note 92.

109. *Id.*

110. LES COLEMAN, RISK STRATEGIES: DIALLING UP OPTIMUM FIRM RISK 106–07 (2009).

111. *Id.* at 107.

112. *Id.*

113. See Morgenson, *supra* note 1.

114. See *id.*

payouts on CDSs.¹¹⁵ When AIG's ability to satisfy its liabilities became increasingly dubious, credit-rating agencies lowered AIG's credit rating.¹¹⁶ When AIG's credit rating decreased, it was required by its CDS contracts to put up more collateral to guarantee its obligations.¹¹⁷ Unable to satisfy its CDSs and collateral obligations or secure private funds to balance its books, AIG was forced to seek government assistance.¹¹⁸

AIG's exposure to CDSs meant that protection purchasers were depending on AIG to satisfy its end of \$440 billion in CDSs.¹¹⁹ Default by AIG on its CDS obligations would have caused further disruption in the economy, resulting in default through a vast network of protection purchasers, including banks and hedge funds.¹²⁰ Because of the broad implications of an AIG collapse for the rest of the economy, the Federal Reserve stepped in on September 16, 2008, authorizing credit of up to \$85 billion—later increased to \$182 billion—to shore up the insurance company's balance sheet.¹²¹

C. Similarities Between Greece and AIG

There were many players common to both the Greek and AIG debacles, but principal among them was Goldman Sachs. Like AIG, the Greek government entered into complex derivatives transactions that hid the risk underlying its position.¹²² In 2001, right before Greece entered the European Union, and again just months before the Greek crisis peaked, Goldman Sachs entered into complex derivatives transactions with Greece that essentially allowed Greece to borrow billions without adding to its public debt.¹²³ AIG brought in billions in premiums on CDSs, many written for Goldman, without tipping off regulators to its precarious position.¹²⁴

Although innovative finance provides markets and society in general with many benefits, it has proven to be a risky business, contributing to financial meltdown and the global recession. Both the AIG

115. Gretchen Morgenson, *No Bottom Yet to AIG Money Pit*, N.Y. TIMES, Mar. 8, 2009, <http://www.nytimes.com/2009/03/08/business/worldbusiness/08iht-morg09.1.20669158.html>.

116. See Morgenson, *supra* note 92.

117. Morgenson, *supra* note 115.

118. *Id.*

119. *See id.*

120. See Louise Story & Gretchen Morgenson, *In U.S. Bailout of A.I.G., Forgiveness for Big Banks*, N.Y. TIMES, June 29, 2010, <http://www.nytimes.com/2010/06/30/business/30aig.html>.

121. *Id.*

122. See Louise Story, *Wall St. Helped to Mask Debt Fueling Europe's Crisis*, N.Y. TIMES, Feb. 13, 2010, <http://www.nytimes.com/2010/02/14/business/global/14debt.html>.

123. *Id.*

124. See Morgenson & Story, *supra* note 55.

collapse and Greek debt crisis resulted in public bailouts, essentially shifting the cost of poor financial decisionmaking by Wall Street to Main Street. Public outrage over the bailouts has forced legislators to act. The question remains, however: How much regulation is enough?

Legislatures and regulators did not grasp the intricacies of products like CDSs and failed to recognize their potential to bring down the global economy. Even now, with the benefit of hindsight, worldwide regulators struggle to bring together a coordinated solution to what turned out to be a global problem. The U.S. Congress has taken a measured approach, introducing measures designed to bring credit derivatives under the regulatory spotlight. In contrast, the developing European approach calls for greater market transparency and takes aim at speculation, specifically targeting “naked short” positions, including uncovered CDS. The following section examines the restrictive approach and whether insurance provides a useful policy analogue for problems involving credit derivatives.

IV. U.S. REGULATION OF CDSs

A. Introduction

Prior to passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, most credit default swaps were generally unregulated in the United States.¹²⁵ In fact, Congress explicitly kept swaps unregulated when it passed the Commodity Futures Modernization Act of 2000.¹²⁶ The Commodity Futures Modernization Act removed swaps from regulation by the Securities and Exchange Commission (SEC) as securities, although the SEC was given jurisdiction over “fraud, manipulation, [and] insider trading” involving “security-based swaps.”¹²⁷

CDSs—unregulated themselves—are frequently written or purchased, in the first instance, by unregulated parties like hedge funds.¹²⁸ In many cases, these protection sellers hedge their risk by purchasing protection themselves.¹²⁹ In other cases, an investor purchases protection, and when spreads increase, sells an amount of protection equivalent to that purchased.¹³⁰ The investor profits to the extent that premiums on sold protection exceed premiums on purchased protection.

125. See Floyd Norris, *Naked Truth on Default Swaps*, N.Y. TIMES, May 20, 2010, <http://www.nytimes.com/2010/05/21/business/economy/21norris.html>.

126. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 103, 114 Stat. 2763, 2763A-377 (2000).

127. See *id.* § 302, 114 Stat. at 2763A-451.

128. See Pierre-Louis, *supra* note 14, at 88–90.

129. See *id.* at 89–90.

130. See *id.*

These activities create a chain of protection sellers and purchasers, each dependent on the solvency of many others if a credit event occurs. In the financial crisis, AIG was in many instances the last link in numerous CDS chains, having sold protection without hedging its own risks.¹³¹ While many intermediate players had hedged their risks, the potential collapse of AIG threatened numerous CDS counterparties, because all of the parties depended on counterparties up the chain that ended with AIG.¹³² One default by a protection seller like AIG would result in total collapse of the chain.¹³³ While scores of market participants stood to profit from these transactions, they all stood or fell together because of their interconnection. Thus, losses due, for example, to one counterparty's default on a CDS with a notional amount of \$10 million are compounded for each counterparty up the chain. What would have been a \$10 million loss becomes a \$50 or \$100 million loss or more, because default by one protection seller forces default by all protection sellers who purchased protection from the defaulting seller or another party who did.

In addition to creating a chain of dependent transactions that multiplied losses, CDSs also jeopardized banks' balance sheets. CDSs were used by banks to hedge their investments in risky mortgage-backed securities.¹³⁴ When banks used CDSs to hedge their risk, the banks' reserves were freed up.¹³⁵ This additional liquidity was, in many cases, invested in further risky investments.¹³⁶ Then, when the market began to slide and a multitude of credit events occurred simultaneously, financial institutions sought payout on CDSs from entities that were unable to make the payments.¹³⁷ These institutions were left with inadequate reserves and massive uncovered losses. Without government assistance, these entities would have collapsed.

This threatened systemic collapse—which was fended off by the federal bailout—was the worst-case result. The difficulty of assessing counterparty risk on a case-by-case basis precipitated this systemic risk and motivates the Dodd–Frank Wall Street Reform and Consumer Protection Act's focus on transparency in the CDS market. Counterparty risk is particularly difficult to assess in the CDS market, because the market in CDSs is not cleared or conducted on an exchange; instead CDSs are traded in the over-the-counter markets. Over-the-counter trades are negotiated between the buyer and seller, either through brokers or via an electronic trading platform.¹³⁸ Al-

131. See Morgenson, *supra* note 92.

132. See *id.*

133. See *id.*

134. See Morrissey, *supra* note 2.

135. See *id.*

136. See *id.*

137. See *id.*

138. See BLACK'S LAW DICTIONARY 1214 (9th ed. 2009).

though subject to fewer regulations than exchange trading, over-the-counter trading has become highly organized in the past twenty years.

In contrast to over-the-counter trades, exchange traded securities and derivatives are traded on an exchange, which is a third party entity providing facilities bringing buyers and sellers together.¹³⁹ Exchange trades are typically conducted through the exchange's clearinghouse, which acts as a central counterparty for the trades.¹⁴⁰ "Counterparties" to a trade taking place through a clearinghouse do not contract with each other; rather, each party contracts with the clearinghouse.¹⁴¹

Financial regulators were largely in the dark about market participants' total exposure to CDSs. Both regulators and often protection purchasers themselves could not be certain how much exposure protection sellers had to particular reference entities and assets.¹⁴² A protection seller, for instance, may have had a superior credit rating and an apparent ability to make good on a particular CDS obligation, but a seller's net exposure to CDSs could make its position untenable in a system wide downturn. AIG is the most obvious example.

The intersection between this "dark" CDS market and regulated participants like AIG and the investment bank, Bear Stearns, became a hazardous tangle of the visible and invisible. Because the CDS market is unregulated and largely dark, counterparties to AAA-rated AIG-issued CDSs believed that their counterparty-risk was near zero. However, because CDSs are unregulated and traded over-the-counter, no one fully grasped the size of the CDS market or its capacity to bring down the world economy.

B. The Dodd–Frank Wall Street Reform and Consumer Protection Act

1. Introduction to the Act

The Dodd–Frank Wall Street Reform and Consumer Protection Act (the Act)¹⁴³ includes substantial changes for the CDS market, although it stops short of restricting the uncovered purchase of CDSs—as called for by a vocal contingent of commentators.¹⁴⁴ Title VII of the Act includes a number of sections amending the Commodity Exchange

139. *See id.* at 645.

140. BRIAN A. EALES & MOORAD CHOUDHRY, DERIVATIVE INSTRUMENTS: A GUIDE TO THEORY AND PRACTICE 69 (2003).

141. *See id.*; *see also infra* subsection IV.B.3 (discussing "clearing").

142. *See* Pierre-Louis, *supra* note 14, at 88.

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

144. *See, e.g.*, Münchau, *supra* note 37 (arguing that naked credit default swaps are "purely speculative gamble[s]").

Act¹⁴⁵ and the Securities Exchange Act¹⁴⁶ to grant jurisdiction to the Commodity Futures Trading Commission (CFTC) and SEC¹⁴⁷ over what are termed “swaps”¹⁴⁸ and “swaps entities.”¹⁴⁹ The Act also creates the Financial Stability Oversight Council¹⁵⁰ (the Council), a nine member panel charged with overseeing systemic risk to the economy and empowered to take steps to minimize that risk.¹⁵¹ For instance, the Council is given the power to subject non-bank financial companies to federal supervision.¹⁵²

The Act includes four principle components tailored to prevent CDSs from taking an active role in future financial catastrophes. In particular, the Act:

- (1) defines “security-based swaps” to include CDSs,¹⁵³ granting the SEC regulatory authority over CDSs;¹⁵⁴
- (2) requires clearing of CDSs;¹⁵⁵
- (3) requires registration of “swap dealers” and “major swap participants”;¹⁵⁶ and

145. Commodity Exchange Act of 1936, ch. 545, 49 Stat. 1491 (codified as amended at 7 U.S.C. §§ 1–27f).

146. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–77oo).

147. At the time this Article went to press, the SEC and CFTC had proposed joint definitions of “swaps” and “security-based swaps” under the Act. *See* Press Release, Sec. & Exch. Comm’n, SEC Proposes Product Definitions for Swaps (Apr. 27, 2011), available at <http://www.sec.gov/news/press/2011/2011-99.htm>.

148. In this Article, I use the word “swap” to indicate both “swaps,” *see* Dodd–Frank Wall Street Reform and Consumer Protection Act § 721(a)(21), 124 Stat. at 1666–71, and “security-based swaps,” *see id.* § 761, 124 Stat. at 1756–57, unless the context indicates otherwise. Any reference to SEC regulation of swaps should be taken as a reference exclusively to “security-based swaps,” since the CFTC has jurisdiction over “swaps,” *id.* § 722(a), 124 Stat. at 1672, but not “security-based swaps.” *See id.* § 772(b), 124 Stat. at 1801–02. Much of the Act’s treatment of “security-based swaps” and its grant of authority to the SEC are mirrored in the Act’s treatment of “swaps” and its grant of authority to the CFTC. *Compare id.* § 721, 124 Stat. at 1658–72 (defining terms that are relevant primarily to the CFTC under Subtitle A—Regulation of Over-the-Counter Swaps Markets, Part II—Regulation of Swap Markets), *with id.* § 761, 124 Stat. at 1754–59 (defining terms that are relevant primarily to the SEC under Subtitle B—Regulation of Security-Based Swap Markets); *see also id.* § 712, 124 Stat. at 1641–47 (providing a framework for the split of regulatory authority between the SEC and CFTC).

149. *Id.* § 716, 124 Stat. at 1648–51.

150. *Id.* § 111, 124 Stat. at 1392–95.

151. *See id.* § 112(a)(1), 124 Stat. at 1394–95.

152. *See id.* § 113, 124 Stat. at 1398–402.

153. *See id.* § 721(a)(21), 124 Stat. at 1666–67 (listing credit default swaps as a type of “swap”); *id.* § 761(a)(6), 124 Stat. at 1756–57 (defining which types of “swaps” constitute “security-based swaps”).

154. *See id.* § 762(a), 124 Stat. at 1759.

155. *Id.* § 763(a), 124 Stat. at 1762–68.

156. *Id.* § 731, 124 Stat. at 1703.

(4) establishes the “swap pushout rule,”¹⁵⁷ which restricts any government bailout of a “swaps entity.”¹⁵⁸

These four components are discussed in the following sections.

2. SEC/CFTC Jurisdiction Over “Swaps” Under the Act

The Act takes a number of steps necessary to shift CDSs from unregulated instruments to regulated “securities.” First, the Act repeals the provisions of the Securities Act¹⁵⁹ and Gramm-Leach-Bliley Act¹⁶⁰ that prohibited the SEC and the states from regulating swaps.¹⁶¹ Section 302 of the Commodity Futures Modernization Act of 2000¹⁶² amended the Securities Act of 1933 to prohibit the SEC from “registering, or requiring, recommending, or suggesting, the registration . . . of any security-based swap agreement”¹⁶³ The Act repealed two provisions under the Commodity Futures Modernization Act, nullifying the prohibition against SEC regulation.¹⁶⁴

Second, the Act grants the SEC and CFTC specific powers over what it terms “swaps”¹⁶⁵ and “security-based swaps.”¹⁶⁶ The terms encompass a comprehensive panoply of derivatives, including CDSs and other credit derivatives.¹⁶⁷ Generally, CDSs with SEC regulated reference assets—like corporate bonds—are subject to SEC regulation as “security-based swaps.”¹⁶⁸ Many other derivatives that are classified by the Act as “swaps” are subject to the CFTC’s jurisdiction.¹⁶⁹

157. See generally Annette L. Nazareth, *Dodd-Frank Act Finalizes Swap Pushout Rule*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 7, 2010, 9:13AM), <http://blogs.law.harvard.edu/corpgov/2010/07/07/dodd-frank-act-finalizes-swap-pushout-rule/> (discussing the inclusion and major provisions of the “Swap Pushout Rule” in the Act).

158. Dodd-Frank Wall Street Reform and Consumer Protection Act § 716, 124 Stat. at 1648–51.

159. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a (2000)).

160. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (as amended by Sections 301 and 302 of the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, §§ 301–02, 114 Stat. 2763, 2763A-451 (2000)).

161. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 762, 124 Stat. at 1759–62.

162. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

163. *Id.* § 302(a), 114 Stat. at 2763A-451.

164. Dodd-Frank Wall Street Reform and Consumer Protection Act § 762(a), 124 Stat. at 1759 (repealing sections 206B and 206C of the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338).

165. *Id.* § 722(a), 124 Stat. at 1672.

166. *Id.* § 772(b), 124 Stat. at 1801–02.

167. See *id.* § 721(a)(21), 124 Stat. at 1666–67; *id.* § 761(a)(6), 124 Stat. at 1757.

168. See *id.* § 761(a)(6), 124 Stat. at 1756.

169. See *id.* § 722(a), 124 Stat. at 1672.

Treatment of CDSs and other security-based swaps as securities subject to SEC jurisdiction will have a profound effect on the industry. For instance, in addition to classifying CDSs as securities subject to the SEC's jurisdiction, the Act also amends the Securities Act to require that security-based swaps must be issued with a prospectus if issued to a person who is not an "eligible contract participant."¹⁷⁰

3. *Clearing for CDS*

From their inception, CDSs largely have been traded over-the-counter.¹⁷¹ The Act includes a requirement that many more CDS transactions be cleared through a registered clearing agency.¹⁷² Moreover, security-based swaps that are subject to the mandatory clearing requirement must be traded on an SEC regulated exchange or swap execution facility, unless a centralized market for the swap is otherwise unavailable.¹⁷³ The Act does not include a laundry list of swaps that must be cleared. Instead, it empowers the SEC to establish rules to determine which groups, categories, types, and classes of security-based swaps will be subject to the clearing requirement, so the full extent of the clearing requirement will not be known for some time.¹⁷⁴

The uncertainty created by giving the SEC responsibility for determining the scope of the clearing requirement threatens the transparency objectives of the Act—although, swaps that are not subject to the clearing requirement are subject to a reporting requirement.¹⁷⁵ A swap that is not required to be cleared must nevertheless be reported by both counterparties to "a registered swap data repository."¹⁷⁶

In addition to giving the SEC the power to require clearing for security-based swaps, the Act also authorizes the SEC to make swap transaction and pricing data available to the public in order to enhance the price discovery process.¹⁷⁷ The SEC is authorized to require real-time public reporting of all swap transactions, whether cleared or not.¹⁷⁸

In addition to the transparency provided by giving the SEC access to clearing data, the Act also gives the SEC and CFTC the power to collect information and issue reports about abusive swaps, which are swaps and security-based swaps that the agencies determine to be

170. *See id.* § 768(b), 124 Stat. at 1801.

171. CHOUDHRY, *supra* note 31, at 2.

172. Dodd-Frank Wall Street Reform and Consumer Protection Act § 763(a), 124 Stat. at 1762-68.

173. *See id.* § 763(a), 124 Stat. at 1767.

174. *See id.* § 763(a), 124 Stat. at 1763.

175. *Id.* § 766, 124 Stat. at 1797.

176. *Id.* § 727, 124 Stat. at 1696.

177. *Id.*

178. *Id.*

“detrimental to . . . the stability of a financial market . . . or . . . participants in financial markets.”¹⁷⁹

4. *Registration of Swap Dealers and Major Security-Based Swap Participants*

The transparency brought to the CDS market by the Act’s clearing requirement is bolstered by the Act’s grant to the SEC of regulatory authority over persons that qualify as “security-based swap dealers” or “major security-based swap participants.”¹⁸⁰ These provisions will bring the identity of major CDS market participants to light,¹⁸¹ require they meet minimum standards necessary to ensure the stability of the marketplace,¹⁸² and impose recordkeeping requirements on them.¹⁸³ The legislation sets forth a broad definition of security-based swap dealers¹⁸⁴ and major security-based swap participants¹⁸⁵ that

179. *Id.* § 714, 124 Stat. at 1647.

180. *See id.* § 764, 124 Stat. at 1784–96.

181. *See id.* § 764(a), 124 Stat. at 1785.

182. *See id.* § 764(a), 124 Stat. at 1786–88.

183. *See id.* § 764(a), 124 Stat. at 1788–89.

184. *See id.* § 761(a)(6), 124 Stat. at 1758. A “security-based swap dealer” is defined as:

[A]ny person who—

- (i) holds themself out as a dealer in security-based swaps;
- (ii) makes a market in security-based swaps;
- (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or
- (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

Id.

185. *See id.* § 761(a)(6), 124 Stat. at 1755–56. A “major security-based swap participant” is defined as:

[A]ny person—

- (i) who is not a security-based swap dealer; and
- (ii)(I) who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
- (II) whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- (III) that is a financial entity that—
 - (aa) is highly leveraged relative to the amount of capital such entity holds and that is no subject to capital requirements established by an appropriate Federal banking agency; and
 - (bb) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission.

Id.

must register, and it empowers the SEC and CFTC to propose more specific regulation, after public comment, on the new registration requirements.¹⁸⁶

Both security-based swap dealers and major security-based swap participants are subject to a laundry list of requirements and standards, each crafted to ensure that the central players in the market are capable of performing their CDS contracts and do not generate unacceptable levels of systemic risk.¹⁸⁷ Among other requirements, the Act mandates that entities falling into these categories must register with the SEC,¹⁸⁸ satisfy an SEC mandated minimum capital requirement,¹⁸⁹ and report to the SEC on their swaps activities.¹⁹⁰

5. *Restriction on Government Bailouts of Swaps Entities—the “Swap Pushout Rule”*

In part due to the public outcry over the bailouts in the financial sector, section 716 of the Act¹⁹¹ generally prohibits government bailouts in the form of federal assistance¹⁹² to swaps entities.¹⁹³ This rule will motivate some depository institutions to move their swaps

186. *Id.* § 761(b), 124 Stat. at 1759.

187. *See id.* § 764, 124 Stat. at 1784–96. Additionally, the Act requires security-based swap dealers and major swap participants to conform with business conduct standards pertaining to fraud, manipulation, and special entities. *See id.* § 764(a), 124 Stat. at 1789–92. The Act also imposes duties pertaining to monitoring trading, managing risk, disclosing information, implementing conflict of interest systems and procedures, and designating a chief compliance officer. *See id.* § 764, 124 Stat. at 1792–94.

188. *See id.* § 764(a), 124 Stat. at 1785–86.

189. *See id.* § 764(a), 124 Stat. at 1786–88.

190. *See id.* § 764(a), 124 Stat. at 1788–89.

191. *Id.* § 716, 124 Stat. at 1648–51.

192. “Federal Assistance” is defined as:

[T]he use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, Federal Deposit Insurance Corporation insurance or guarantees for the purpose of—

- (A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
- (B) purchasing the assets of any swaps entity;
- (C) guaranteeing any loan or debt issuance of any swaps entity; or
- (D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.

Id. § 716(b)(1), 124 Stat. at 1648.

193. A “swaps entity” is defined as “any swap dealer, security-based swap dealer, major swap participant, [or] major security-based swap participant” that is registered under the Commodity Exchange Act or the Securities Exchange Act of 1934. *Id.* § 716(b)(2)(A), 124 Stat. at 1648. However, if a “major swap participant or major security-based swap participant . . . is an insured depository institution,” then it is excluded from this definition. *Id.* § 716(b)(2)(B), 124 Stat. at 1648.

activities to non-bank affiliates or cease swaps trading altogether.¹⁹⁴ However, exceptions to the general prohibition threaten to swallow the rule, and the exposure of many financial institutions to CDS risk will continue.¹⁹⁵

Major swap participants¹⁹⁶ and major security-based swap participants¹⁹⁷ that are insured depository institutions are excluded from the prohibition on federal assistance.¹⁹⁸ In contrast, insured depository institutions that are major swap dealers are covered by the prohibition on federal assistance, but the prohibition does not cover these institutions if their swap and security-based swap activities are limited to hedging and risk management activities or “acting as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank.”¹⁹⁹ Note that, while these banks are prohibited from dealing in equity securities, they are not prohibited from dealing in investment grade debt securities, which are often CDS reference assets.²⁰⁰

194. *See id.* § 716(c), 124 Stat. at 1648 (“The prohibition on Federal assistance contained in subsection (a) does not apply to and shall not prevent an insured depository institution from having or establishing an affiliate which is a swaps entity . . .”).

195. *See id.* § 716(l), 124 Stat. at 1651. As a catch-all, the Act grants the Financial Stability Oversight Council the authority to prohibit federal assistance for swap entities “when other provisions established by this Act are insufficient to effectively mitigate systemic risk and protect taxpayers.” *Id.*

196. A “major swap participant” is defined as:

[A]ny person who is not a swap dealer, and—

(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—

(I) positions held for hedging or mitigating commercial risk; and

(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

(iii)(I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

Id. § 721(a)(16), 124 Stat. at 1663.

197. *Id.* § 761(a)(6), 124 Stat. at 1755–56

198. *Id.* § 716(b)(2)(B), 124 Stat. at 1648.

199. *Id.* § 716(d)(2), 124 Stat. at 1648.

200. *See id.*; *see also* 12 U.S.C. § 24 (2006) (“As used in this section the term “investment securities” shall mean marketable obligations, evidencing indebtedness of any person . . . in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term “investment se-

The Act also prohibits the use of taxpayer funds to prevent a swaps entity's receivership resulting from swap activity if that entity is FDIC insured or designated as "systemically significant."²⁰¹ An FDIC insured or systemically significant swap institution that is declared insolvent or is put into receivership due to swap activity may have its swap activity terminated or transferred.²⁰² Taxpayer funds are prohibited from being used to liquidate a swaps entity that is not FDIC insured and not systemically significant.²⁰³ The Act also includes a broad prohibition that "[t]axpayers shall bear no losses from the exercise of any authority under" Title VII of the Act, including all of the provisions relating to swaps and security-based swaps activity.²⁰⁴

In addition to prohibiting federal bailouts of swaps entities, the Act also prohibits banks and bank holding companies from being or becoming swaps entities unless satisfying minimum standards set by the bank's prudential regulator.²⁰⁵ The prudential regulators are given wide regulatory latitude to ensure that banks that are or become swaps entities are not a threat to systemic financial stability.²⁰⁶

Although the pushout rule goes a long way toward mitigating the extent to which banks socialize the costs of risky swaps transactions, the rule does not prohibit an insured depository institution from establishing or having an affiliate that is a swaps entity, subject to some limitations.²⁰⁷

V. EUROPEAN PROPOSALS FOR REGULATION OF CDSs

While the U.S. regulatory response to CDSs is motivated in large part by the sub-prime mortgage crisis, the threatened collapse of AIG, and the obliteration of hundreds of U.S. banks, the prime motivator

curities' as may by regulation be prescribed by the Comptroller of the Currency.").

201. Dodd-Frank Wall Street Reform and Consumer Protection Act § 716(i)(1)(B), 124 Stat. at 1650.

202. *Id.*

203. *Id.* § 716(i)(1)(C), 124 Stat. at 1650.

204. *Id.* § 716(i)(3), 124 Stat. at 1650.

205. *Id.* § 716(j), 124 Stat. at 1650.

206. *Id.*

207. *See id.* § 716(c); 124 Stat. at 1648. A depository institution may have an affiliate who is a swaps entity and not be prohibited from receiving federal assistance, so long as:

[S]uch insured depository institution is part of a bank holding company, or savings and loan holding company, that is supervised by the Federal Reserve and such swaps entity affiliate complies with sections 23A and 23B of the Federal Reserve Act and such other requirements as the Commodity Futures Trading Commission or the Securities Exchange Commission, as appropriate, and the Board of Governors of the Federal Reserve System, may determine to be necessary and appropriate.

Id.

behind the European response appears to be the financial instability of regional (but sovereign) governments, like Greece. CDSs written on Greece's sovereign debt are blamed for increasing the Greek government's cost of borrowing and decreasing investor confidence in its stability, amplifying the debt crisis and ultimately necessitating a bailout by the IMF.²⁰⁸ Shortly after the Greek debt crisis surfaced early in 2010, financial speculators were targeted as exacerbating the problem.²⁰⁹ In response to the perception that speculators were responsible for intensifying the crisis, José Manuel Durão Barroso, President of the European Commission—the European Union's executive agency—announced that the Commission would consider a ban on naked short selling and uncovered sovereign CDSs—those CDSs that use government issued debt as their reference entity.²¹⁰ He justified a potential ban by reference to insurance: "It's hard to justify why market players should purchase insurance against risks to which they are not themselves exposed."²¹¹ Greek Prime Minister George Papandreou also spoke out early in the crisis blaming speculators—including investors who purchase CDSs without owning the underlying reference asset—for its rapid escalation.²¹²

Prompted by the Greek crisis, Germany unilaterally banned short selling and uncovered CDSs in Eurozone debt on May 19, 2010.²¹³ The ban was temporary and scheduled to last for one year.²¹⁴ The German financial regulator, BaFin, has stated that it banned the transactions in an effort to increase stability in the debt markets.²¹⁵ Although France initially balked at Germany's unilateral action, within a month after the ban French President Nicholas Sarkozy joined with German Chancellor Angela Merkel to call for a ban on naked short selling and trading in uncovered sovereign CDSs.²¹⁶ Writ-

208. See Schwartz & Dash, *supra* note 19.

209. See *id.*

210. Stephen Fidler et al., *Swaps Come Under Fire*, WALL ST. J., Mar. 10, 2010, <http://online.wsj.com/article/SB10001424052748704784904575111191528470212.html>.

211. *Id.*

212. See Hillary Clinton, U.S. Sec'y of State, Remarks with Greek Prime Minister George Papandreou After Their Meeting (Mar. 8, 2010), available at <http://www.state.gov/secretary/rm/2010/03/137951.htm>; see also Rebecca Christie, *Papandreou Sees 'New Will' in EU to Manage Crises*, BLOOMBERG (Mar. 10, 2010, 12:14 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=A25PYtTYmgzs> (explaining that Prime Minister Papandreou views the regulation of speculators as necessary for Greece's austerity measures to succeed).

213. See Geir Moulson, *German Regulator Issues Naked Short-Selling Ban*, USA TODAY, May 19, 2010, http://www.usatoday.com/money/world/2010-05-18-germany-naked-short-selling_N.htm.

214. See *id.*

215. See *id.*

216. See *Germany, France Urge EU-Wide Ban on 'Naked' Short-Selling*, CNN (June 9, 2010, 8:24 AM), <http://www.cnn.com/2010/BUSINESS/06/09/europe.short.selling/index.html>.

ing together, they stated, “The [European Commission’s] work should encompass the possibility of an EU-wide prohibition of naked short selling of all or certain shares and sovereign bonds as well as of all or certain naked sovereign CDS (credit default swaps) and its conditions.”²¹⁷

The European Commission pulled back from its initial consideration of a ban on naked CDSs in Eurozone debt.²¹⁸ Motivated by the weakening of the Euro by the Greek crisis, the European Commission summoned its member states to Brussels in May 2010 to discuss the regulation of sovereign CDSs. The meeting culminated with the Commission backing a plan to ban some types of speculative trading in sovereign CDSs.²¹⁹ Using the results from its investigation, the Commission proposed regulations on September 15, 2010, that will provide an EU-wide, coordinated response to “disorderly markets and systemic risks.”²²⁰

The EU’s financial reform strategy includes emergency powers under which member states will be given the power to restrict or entirely prohibit particular types of CDS transactions.²²¹ Exercise of these emergency powers would be limited initially to a duration of three months²²² and would require members to coordinate any ban or restriction through the newly formed European Securities Market Authority (ESMA).²²³

The proposed regulations would also introduce transparency requirements into some trades in CDSs relating to EU sovereign debt issuers. Persons with uncovered positions or net short positions in sovereign debt would be required to privately inform member state regulators of their net short positions.²²⁴ Member states also would be given the power under the regulations to enact further trans-

217. *See id.*

218. *See* James Kanter, *E.U. Refuses to Be Rushed on Regulating Financial Practices*, N.Y. TIMES, June, 9, 2010, <http://www.nytimes.com/2010/06/10/business/global/10euro.html>.

219. *See* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank—Regulating Fin. Servs. for Sustainable Growth, EUROPA, 8 (June 2, 2010), http://ec.europa.eu/internal_market/finances/docs/general/com2010_en.pdf.

220. Press Release, European Comm’n, New Framework to Increase Transparency and Ensure Coordination for Short Selling and Credit Default Swaps (Sept. 15, 2010), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1126&format=HTML&aged=0&language=EN&guiLanguage=en>.

221. *See* EC Proposed Regulation, *supra* note 40, arts. 16–19.

222. *See id.* art. 20. Under the proposed regulation, any emergency measure enacted by a member state is only initially valid for a period of three months; however, an emergency measure “may be renewed for further periods not exceeding three months at a time.” *Id.*

223. *See id.* arts. 22, 23.

224. *See id.* art. 8.

parency measures—such as requiring the public disclosure of market participants’ short positions—in emergency situations.²²⁵

Although the EU pulled back from completely banning uncovered CDSs, its strongest members have demonstrated a willingness to restrict uncovered trades. On July 9, 2010, Germany’s Parliament passed legislation prohibiting some naked short selling and uncovered Eurozone sovereign CDS positions.²²⁶ The ban was inapplicable if the protection purchaser was hedging a position in the CDS’s reference assets and the purchase of protection would result in a “significant reduction of the credit risk deriving from the existing position.”²²⁷

Germany’s requirement that protection purchasers be exposed to credit risk in the CDS’s reference obligation harkens to the often repeated comparisons between CDSs and insurance policies. An insurance policy cannot be purchased unless the purchaser has a financial—or in the case of life insurance, familial—interest in the risk insured under the policy.²²⁸ This *insurable interest* requirement has largely prevented speculation or gambling in insurance policies for hundreds of years.²²⁹ Germany’s statute essentially requires that a protection purchaser have an insurable interest in the CDS’s reference assets. The question is whether this curb on speculation will contribute to greater financial stability. The next three sections of this Article examine whether imposition of an *insurable interest* requirement on CDSs is an effective means of ensuring that CDSs do not contribute to future financial catastrophes.

VI. THE INSURABLE INTEREST REQUIREMENT

A. Introduction

The argument that credit default swaps should be regulated like insurance policies was made succinctly by George Soros: “Credit default swaps (CDS) are particularly dangerous [because] they allow people to buy insurance on the survival of a company or a country while handing them a license to kill. CDS[s] ought to be available to buyers only to the extent that they have a legitimate insurable inter-

225. *See id.* art. 16.

226. DEUTSCHER BUNDESTAG: DRUCKSACHEN [BT] 17/1952 (Ger.); *see also* CLIFFORD CHANCE, GERMAN PARLIAMENT ADOPTS BAN ON NAKED SHORT-SELLING AND UNCOVERED SOVEREIGN CDS TRADING—UPDATE 4, at 1 (2010), available at http://www.cliffordchance.com/publicationviews/publications/2010/07/germany_bans_nakedshort-sellinganduncovere.html [hereinafter GERMAN PARLIAMENT ADOPTS BAN] (explaining the provisions of the German ban).

227. *See* GERMAN PARLIAMENT ADOPTS BAN, *supra* note 226, at 2.

228. *See* RAY HODGIN, INSURANCE LAW: TEXT AND MATERIALS 56–57 (2d ed. 2002).

229. *See id.* at 55–56.

est.”²³⁰ Likewise, Philip Gisdakis, head of credit strategy at UniCredit in Munich, described the danger of CDSs in insurance terms: “It’s like buying fire insurance on your neighbor’s house—you create an incentive to burn down the house.”²³¹

A person who is permitted to purchase an insurance policy on a neighbor’s property has no incentive—other than the threat of criminal prosecution—to preserve his neighbor’s property.²³² It is in the policy purchaser’s best financial interest for the property to be destroyed, since he or she is paying premiums on the policy and will see a return on that investment only if the property is destroyed. Likewise, it is argued, an investor who is permitted to purchase a credit default swap on a bond that the investor does not own has an incentive to manipulate the market in order to weaken the CDS’s reference entity and force a default.²³³

B. Origin of the Insurable Interest Requirement

The law discourages the purchase of insurance on a stranger’s property by imposing an insurable interest requirement on insurance policies.²³⁴ Because of the similar risks presented by CDSs and insurance policies, it is argued that imposition of an insurable interest requirement on CDSs is the appropriate regulatory means of eliminating the incentive to manipulate the financial stability of reference entities.²³⁵

The insurable interest requirement developed on the heels of the British life insurance market. More than 200 years before the late twentieth century development of the secondary market for life insurance and stranger-originated life insurance (STOLI),²³⁶ London had a

230. George Soros, Inst. of Int’l Fin. Spring Membership Meeting Address, Vienna (June 10, 2010), available at http://www.georgesoros.com/interviews-speeches/entry/iif_spring_membership_meeting_address_june_10_20101/.

231. Schwartz & Dash, *supra* note 19.

232. See KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 201 (4th ed. 2005) (“The predominant justification now given for the requirement of an insurable interest is that it combats moral hazard: in the absence of an insurable interest held by the party procuring insurance, the incentive to destroy insured property or persons would be considerably greater.”).

233. See, e.g., Soros, *supra* note 230.

234. See ABRAHAM, *supra* note 232.

235. E.g., Soros, *supra* note 230.

236. See *N.Y. Court Says You Can Sell Your Life Insurance Policy*, USA TODAY, Nov. 17, 2010, http://www.usatoday.com/money/perfi/insurance/2010-11-17-life-insurance-sale_N.htm; see also Robert S. Bloink, *Catalysts for Clarification: Modern Twists on the Insurable Interest Requirement for Life Insurance*, 16 CONN. INS. L.J. (forthcoming 2011) (discussing at length the insurable interest requirement for life insurance).

bustling market in stranger-initiated policies.²³⁷ Where the modern secondary market is an ordered, developed market, the eighteenth century market more resembled an underground gambling house.²³⁸ The commodity “traded” in these exchanges—which often took place in social settings—was life insurance policies, often taken out on the lives of the famous.²³⁹ The price of policies in London increased or decreased depending on the health or military success of the insured.²⁴⁰ These practices eventually led to public condemnation of the practice of gambling on the lives of others, and Parliament passed the Gambling Act of 1774, which outlawed the purchase of insurance on a life or event if the purchaser does not have an interest—referred to as an “insurable interest”—in the subject matter of the policy.²⁴¹

In the life insurance context, an insurable interest in the life of an individual is based on either: (1) “love and affection” or (2) a “substantial economic interest” in the continued life of that individual.²⁴² “Love and affection” typically manifests itself as a close familial relationship, and a “substantial economic interest” generally results from a business relationship.²⁴³ With respect to fire insurance, an insurable interest is limited to a financial interest—like ownership or a mortgage interest—in the property insured.²⁴⁴

The insurable interest requirement for life insurance was inspired by two related policy considerations: (1) the moral hazard of allowing a person to purchase life insurance on an unrelated stranger; and (2) the perceived immorality of gambling on human lives.²⁴⁵ The moral

237. GEOFFREY CLARK, *BETTING ON LIVES: THE CULTURE OF LIFE INSURANCE IN ENGLAND, 1695–1775*, at 49–53 (1999).

238. *See id.*

239. *See id.* at 49 (“Bets on lives took place in a variety of genteel settings, such as at dinner parties and in gentlemen’s clubs, but insurance offices served as the primary site for such wagers Men and women in the public eye usually supplied the subjects for these gaming policies”).

240. *See id.* at 49–50 (“Higher premiums were charged, for example, on the much-insured life of Robert Walpole during the Excise Crisis; and during the Jacobite rebellion of 1745 the price of policies on the lives of the Pretender and the rebel lords rose or fell with each new report of their military advance.”).

241. *See id.* at 53; *see also* Bloink, *supra* note 236.

242. *See* ABRAHAM, *supra* note 232, at 7.

243. *See, e.g.*, CAL. INS. CODE § 10110.1(a) (West 2010).

An insurable interest, with reference to life and disability insurance, is an interest based upon a reasonable expectation of pecuniary advantage through the continued life, health, or bodily safety of another person and consequent loss by reason of that person’s death or disability or a substantial interest engendered by love and affection in the case of individuals closely related by blood or law.

Id.

244. *See, e.g., id.* § 281.

245. *See* ABRAHAM, *supra* note 232, at 7.

hazard problem exists for all types of insurance.²⁴⁶ A moral hazard is present when a policy is purchased without an insurable interest because the policy purchaser may be motivated to accelerate the return on his investment by killing the insured individual or destroying the insured property.²⁴⁷ Presumably there will be countervailing forces—love and affection or a financial interest—that disincentive destruction of the subject of the policy when the party purchasing insurance has an insurable interest.²⁴⁸

C. New York's Attempt to Regulate CDSs as Insurance

The New York State Insurance Department (NYSID) previously has considered regulating CDSs as insurance. Although New York's insurance law and administrative regulations do not specify whether CDSs are subject to regulation as insurance products, the NYSID issued opinions and circular letters expressing its intent to regulate some CDSs.

The NYSID's first major action with respect to CDSs was to issue a private opinion letter excluding *some* CDSs from regulation as insurance contracts.²⁴⁹ Specifically, a CDS with a payout that is "not dependent upon the buyer having suffered a loss" was excluded from being classified as insurance.²⁵⁰ The opinion is ambiguous on some points, but clearly a CDS issued to a speculator who does not own the CDS's reference obligations would never be treated as insurance under the NYSID's opinion.²⁵¹ Also derivable from the opinion is that a CDS, the payout of which is dependent on the purchaser's loss, may be classified as an insurance contract.²⁵²

The NYSID promised to clarify its position on CDSs in a Circular Letter made available on September 22, 2008.²⁵³ The NYSID expressed its intention to explain whether "a CDS is an insurance contract when it is purchased by a party who, at the time at which the

246. See *Grigsby v. Russell*, 222 U.S. 149 (1911) (life insurance); *Studio Frames Ltd. v. Standard Fire Ins.*, 483 F.3d 239 (4th Cir. 2007) (fire insurance); see also Bloink, *supra* note 236 (discussing both life and property insurance).

247. See ABRAHAM, *supra* note 232, at 7.

248. See *id.*; see also Bloink, *supra* note 236 (discussing countervailing forces). See generally Ben Kingree & Louise Tanner, *Life Insurance as Motive for Murder*, 29 TORT & INS. L.J. 761 (1994) (discussing moral hazard with respect to life insurance policies).

249. See Letter from Rochelle Katz, Office of Gen. Counsel of the N.Y. State Ins. Dep't, to Bertil Lundqvist, Skadden, Arps, Slate, Meagher & Flom (June 16, 2000), available at <http://c0181567.cdn1.cloudfiles.rackspacecloud.com/2000-06-16%20NYSID%20Credit%20Default%20Option%20Facility.pdf>.

250. *Id.*

251. See *id.*

252. See *id.*

253. N.Y. STATE INS. DEP'T, CIRCULAR LETTER NO. 19 (Sept. 22, 2008), available at http://www.ins.state.ny.us/circltr/2008/cl08_19.pdf.

agreement is entered into, holds, or reasonably expects to hold, a ‘material interest’ in the referenced obligation.”²⁵⁴ In other words, the NYSID was grappling with the question of whether a CDS is an insurance contract when it is issued to a party with an insurable interest in the reference obligations.

Classification of CDSs as insurance faced stiff resistance from derivative market trade groups. A joint letter written by the Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association (ISDA) clearly states what they view as the fundamental distinctions between CDSs and insurance:

There are a number of characteristics that distinguish the two. Whereas insurance requires an insurable interest, credit default swaps are often purchased by protection buyers that are not hedging a specific underlying risk. Insurance contracts generally are purchased and held by the buyer, whereas CDS are frequently bought and sold. And finally, insurance contracts only pay out when the insured party actually incurs a loss. CDS provide for payments to protection buyers upon the occurrence of a credit event, which frequently occurs before any loss is incurred. We believe each of these factors marks a significant difference between CDS and insurance.²⁵⁵

Under pressure, the NYSID retreated from its prior willingness to regulate CDSs as insurance, issuing a November 20, 2008, supplement to its previous circular: “In light of [the] progress made toward comprehensive federal regulation of CDS, New York will delay indefinitely its application of New York Insurance Law to CDS[s].”²⁵⁶ Efforts to incorporate these insurance regulatory concepts, and specifically an insurable interest requirement, failed to gain inclusion in the Act signed into law by president Obama in August 2010.²⁵⁷

D. Insurable Interest Requirement Would Stop Market Manipulation by Speculators in CDSs

It is unsurprising that the insurable interest requirement has frequently been mentioned in the CDS context.²⁵⁸ CDSs are often re-

254. *Id.* at 7.

255. Letter from Cory Strupp, Managing Dir. of the Sec. Indus. and Fin. Mkt. Ass’n, and Katherine Darras, Gen. Counsel, Int’l Swaps and Derivatives Ass’n, Inc., to Joseph Morelle, Chairman of the Task Force on Credit Default Swaps Regulation, Nat’l Conference of Ins. Legislators (May 22, 2009), available at <http://www.isda.org/speeches/pdf/NCOIL-Letter.pdf>.

256. N.Y. STATE INS. DEP’T, FIRST SUPPLEMENT TO CIRCULAR LETTER NO. 19 (Nov. 20, 2008), available at http://www.ins.state.ny.us/circltr/2008/cl08_19s1.htm.

257. See Ronald D. Orol, *Senators Reject Effort to End Debate on Bank Bill*, MARKETWATCH (May 19, 2010, 5:39 PM), <http://www.marketwatch.com/story/rejection-of-democrat-measures-may-slow-bank-bill-2010-05-19> (discussing the Senate’s rejection of Senator Dorgan’s amendment, which would have imposed an insurable interest requirement under the Act).

258. See, e.g., Nelson D. Schwartz & Eric Dash, *Banks Bet Greece Defaults on Debt They Helped Hide*, N.Y. TIMES, Feb. 24, 2010, <http://www.nytimes.com/2010/02/>

ferred to as a “type of insurance,”²⁵⁹ and a primary source of public discomfort over CDSs is the fact that speculators—like the life insurance speculators of eighteenth century London—are essentially “insuring” assets that they do not own. Investors who purchase CDS protection without owning the associated credit instrument have an incentive to manipulate the market to force the credit event that will trigger payout on the CDS.

Imposing an insurable interest requirement on CDSs—requiring protection purchasers to have economic exposure to the associated credit instrument—would eliminate any market manipulation or distortion resulting from CDSs. A person who owns or otherwise has an economic interest in debt of the CDS’s reference entity is generally disincentivised from encouraging or forcing the reference entity’s default, since any payout from the CDS will be offset by the purchaser’s losses on the reference entity’s debt.²⁶⁰ While a blanket prohibition on uncovered CDSs would eliminate the potential for market manipulation or distortion, the proposition of imposing an insurable interest requirement on CDSs is not without its downsides.²⁶¹ The remainder of this Article will examine the limitations involved in the comparison of a CDS to fire insurance and the impact of an insurable interest requirement on the CDS and broader credit markets.

VII. NAKED SHORT SELLING AND UNCOVERED CREDIT DEFAULT SWAPS

The policy of allowing a market in uncovered CDSs—sometimes referred to in the media as “naked” CDSs—is often criticized in the same breath as condemnation of naked short selling.²⁶² In testimony delivered to the Senate Banking Committee in 2008, Christopher Cox, Chairman of the SEC, went so far as to equate the purchasing of CDS protection without ownership of the reference obligation to naked short selling the debt:

Economically, a CDS buyer is tantamount to a short seller of the bond underlying the CDS. Whereas a person who owns a bond profits when its issuer is in a position to repay the bond, a short seller profits when, among other

25/business/global/25swaps.html (“It’s like buying fire insurance on your neighbor’s house—you create an incentive to burn down the house.”).

259. *E.g.*, Jana Randow & Francine Lacqua, *Trichet Pushes for Transparency Around Credit Default Swaps*, BLOOMBERG BUSINESSWEEK, Mar. 19, 2010, available at <http://www.businessweek.com/news/2010-03-19/trichet-pushes-for-transparency-around-credit-default-swaps.html>.

260. *See* ABRAHAM, *supra* note 232, at 7 (explaining the insurable interest of “love and affection” as a general disincentive to kill).

261. *See* discussion *infra* Part VIII (analyzing the social costs of a ban on uncovered CDS positions).

262. *See* Germany, France Urge EU-Wide Ban on ‘Naked’ Short-Selling, *supra* note 216.

things, the bond goes into default. Importantly, CDS buyers do not have to own the bond or other debt instrument upon which a CDS contract is based. *This means CDS buyers can “naked short” the debt of companies without restriction.* This potential for unfettered naked shorting and the lack of regulation in this market are cause for great concern.²⁶³

The following section demonstrates that the purchase of an uncovered CDS is not equivalent to naked short selling—which is in many cases a socially undesirable activity without redeeming social value. The transactions have little in common, differing in contractual structure and their capacity to be used as a tool to manipulate markets. First, the concept of short-selling is introduced, distinguishing between a typical short sale and a naked short. Next, U.S. regulation of short selling is briefly discussed, with emphasis on regulation of naked short selling. Finally, naked short selling and uncovered CDSs are distinguished.

A. Introduction to Short-Selling and Naked Short Selling

Short sales are made with the expectation that the price of the security sold short will decrease; it is essentially a bet against the value of the security.²⁶⁴ Like a person purchasing protection in a CDS, a short seller will gain on the transaction when the asset underlying the transaction decreases in value.²⁶⁵ Both are essentially betting on, or hedging against, the value of the underlying security decreasing: the investor profits when the value of the security decreases.²⁶⁶ A person who makes a short sale is said to take a “short position” in the security.²⁶⁷ A person purchasing a security outright is said to take a “long position” in the security.²⁶⁸

A short sale is conducted by borrowing, or arranging to borrow, a security and then immediately selling the borrowed security on the market.²⁶⁹ Then, if the value of the security decreases, the short seller will purchase an identical security on the market for its de-

263. *Turmoil in the U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008) (statement of Christopher Cox, Chairman, Securities and Exchange Commission) (emphasis added), available at <http://www.sec.gov/news/testimony/2008/ts092308cc.htm>.

264. See TOM TAULLI, WHAT IS SHORT SELLING? 2–4 (2004).

265. See *id.* at 3–4.

266. See *id.*

267. See *id.* at 4.

268. See *id.* A person who short sells a particular security may also be referred to as being “short” with respect to the security. See *id.* In contrast, a “long position” is taken when a party purchases a security outright. See *id.*

269. See *id.* at 3–4; see also 17 C.F.R. § 242.200(a) (2010) (defining “short sale” as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller”). Short selling is not exclusive to securities. Commodities and other assets can be

creased price and return that security to the securities lender.²⁷⁰ The security that is sold in a short sale is typically borrowed from the seller's broker, who borrows the security from another of the broker's customers.²⁷¹ The seller typically pays a lending fee to the broker.²⁷² A short position is "closed" by the investor by "covering" the short position; the short position is covered by purchasing securities on the market to return to the lender.²⁷³

If the price of the security sold short has decreased in the interval during which the investor was short, the investor will profit to the extent of the difference between the beginning price and closing price, less fees associated with the short sale.²⁷⁴ If the price of the security increased over the interval during which the investor was short, the investor will realize a loss to the extent of the difference between the beginning price and the closing price, increased by fees associated with the short sale.²⁷⁵

For example, investor A commences a short sale of stock ABC when ABC is trading at \$10 per share. Investor A borrows stock ABC and immediately resells it on the open market at \$10. The price of ABC then drops to \$5, and A covers by purchasing stock ABC on the market and returning that stock to the lender. If transactions fees are \$2.50 on the short sale, A will make a profit on the sale of \$2.50. However, if the price of ABC increases to \$15 before A closes the short position, A will realize a loss of \$7.50 when A purchases ABC on the market for \$15 and transfers that stock to the lender.

Note that the price of a security can never decrease below \$0.²⁷⁶ Thus, profit on a short sale is limited to the full price of the security at the time the short seller makes the short sale.²⁷⁷ In contrast, the potential loss on a short sale is essentially unlimited, since the price of a security could theoretically continue to rise indefinitely, continuously increasing the short seller's losses.²⁷⁸ In reality, losses on a short sale will be limited when the investor closes out the short position or is unable to answer a margin call, and the short seller's broker forcibly closes the short position.²⁷⁹

shorted, but for the sake of simplicity, we will refer exclusively to short selling of securities, including stocks and bonds.

270. See TAULLI, *supra* note 264, at 3–4.

271. See *id.*

272. See *id.* at 27–28. Institutional investors typically do not pay interest costs unless the stock is small or hard to borrow. *Id.* at 28.

273. See *id.* at 4.

274. See *id.*

275. See *id.*

276. See *id.* at 29.

277. See *id.*

278. See *id.*

279. See *id.* at 30.

Naked short sales. A naked short sale is a short sale in which the short seller does not borrow or arrange to borrow a security before making a short sale.²⁸⁰ A short seller benefits from making a naked short sale over making a covered short sale for the following reasons:

1. Reduced transactions costs—a naked short seller does not necessarily borrow the shorted security and will not pay lending fees.²⁸¹
2. Enhanced liquidity and rapid response to market conditions—when a security is difficult or impossible to locate for purchase, naked short selling enhances liquidity by providing willing purchasers with a source for purchase of the security.²⁸²

Fails to deliver. If the security sold in a naked short sale is not purchased or borrowed by the short seller and delivered to the purchaser by the settlement date, then the short seller has failed to deliver.²⁸³ Under U.S. securities law, the settlement date for securities is the third day after the transaction date (referred to as “T+3”).²⁸⁴ A “fail to deliver” will occur if a security is not delivered when due.²⁸⁵

B. U.S. Regulation of Naked Short Selling

In the press given to the German ban on short selling,²⁸⁶ very little attention was paid to the fact that the U.S. essentially banned short selling in 2005, adopting increasingly strict regulations since that time.

The SEC has adopted a number of rules relating to short selling. Regulation SHO, adopted by the SEC on July 28, 2004,²⁸⁷ includes two primary components aimed at curbing short-selling: (1) a requirement that broker-dealers “locate securities available for borrowing” before accepting a short sale order or making a short sale on its own account,²⁸⁸ and (2) a requirement that all fails-to-deliver be closed out “no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver

280. See Short Sales, Exchange Act Release No. 50013, 69 Fed. Reg. 48008, 48009 n.10 (Aug. 6, 2004).

281. See Amendments to Regulation SHO, Exchange Act Release No. 60388, 74 Fed. Reg. 38266, 38267 (July 31, 2009).

282. The liquidity boost provided by naked short selling was recognized by the SEC in its original Regulation SHO, which included an exception to the Regulation’s locate requirement. See Short Sales, 69 Fed. Reg. at 48009 n.6.

283. See Amendments to Regulation SHO, 74 Fed. Reg. at 38266 n.2.

284. See *id.* at 38267 n.16.

285. See *id.* at 38266 n.2.

286. See discussion *supra* Part V.

287. See Short Sales, 69 Fed. Reg. at 48030–31.

288. See 17 C.F.R. 242.203 (2010); see also Short Sales, 69 Fed. Reg. at 48009 (providing a detailed description of Regulation SHO).

position.”²⁸⁹ Broker-dealers are required to close out short positions after fails-to-deliver and may be restricted from further short selling until the positions are closed.²⁹⁰

Any naked short selling transaction will violate Regulation SHO, since, by definition, a naked short sale is a short sale made without borrowing or locating a security to borrow.²⁹¹ The location requirement ensures that a naked short seller does not simply locate a security to borrow and then fail to borrow it. Violation of SHO can result in penalties for brokers involved in the sale, including fines and restrictions on future short selling activities.²⁹²

C. Distinctions Between Naked Short Selling and Uncovered CDSs

The U.S. prohibits naked short selling, so why not prohibit other uncovered transactions, like uncovered CDSs? Both types of transactions permit a speculator to take an essentially unlimited short position in a security without the expense of borrowing the security and without any limits imposed by liquidity and volume. Despite this apparent similarity, important distinctions exist between naked short sales and CDSs.

The first distinction between short selling and uncovered CDSs is the structure of the transaction. A short selling transaction involves the lending and sale of a particular security, and a naked short sale is an imperfect short sale where a lender has not been secured and the security is not delivered to the buyer as per the terms of the sale.²⁹³ In contrast, a CDS is a derivative transaction that does not involve the sale and delivery of a security.²⁹⁴ The reference obligation is only indexed by the CDS contract as a touchstone for whether a payout will be made to the buyer.²⁹⁵ The protection buyer and seller are in privity with each other, and the contract can be completely performed without the necessity of a third party's involvement.²⁹⁶

Further, the “naked” component of a naked short sale refers to the seller failing to hold up his end of a sales contract. In U.S. securities

289. 17 C.F.R. 242.204 (2010); *see also* Amendments to Regulation SHO, 74 Fed. Reg. at 38266 (explaining that a participant who has failed to deliver must immediately purchase or borrow securities to close out the fail to deliver within the designated time).

290. *See* Amendments to Regulation SHO, 74 Fed. Reg. at 38266.

291. *See* TAULLI, *supra* note 264, at 3.

292. *See* Amendments to Regulation SHO, 74 Fed. Reg. at 38266.

293. *See id.* at 38266 n.2.

294. *See* CHOUDHRY, *supra* note 31, at 5 (“Credit derivative instruments enable participants in the financial market to trade in credit as an asset, as they isolate and transfer credit risk.”).

295. *See id.* at 8–10.

296. *See id.*

sales, the seller is required to make delivery to the buyer within three days of the trade date.²⁹⁷ A naked short is “the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.”²⁹⁸ The purchaser has not agreed to participate in a naked short sale, which essentially converts a security into an undated futures contract without the other party’s assent.²⁹⁹ The counterparty may have priced the transaction differently or refused to enter the transaction if the seller’s intent had been made known at its inception.³⁰⁰

In contrast to a naked short sale, an uncovered CDS is a contract between two sophisticated parties who are each aware of the risks and benefits of the transaction.³⁰¹ Each has had an opportunity to conduct due diligence in light of the counterparty risks inherent in a CDS. While there may be a differential between the counterparties’ sophistication and information in a CDS transaction, that information imbalance is not inherent in the structure of the transaction, as it is in the case of naked short selling.

In addition to structural differences between naked short sales and uncovered CDSs, the transactions also differ in their effects on the market. Naked short sales have a direct effect on the price of the security involved in the transaction.³⁰² In a naked short sale, the liquidity and trading volume of the security being shorted is artificially inflated.³⁰³ The seller is selling a security that he does not own, thus effectively creating a “phantom share.”³⁰⁴ In fact, the number of fails-to-deliver may be larger than the total public float in thinly capitalized companies.³⁰⁵ In contrast, a CDS is not a transaction in the reference security at all, and it does not have a direct effect on the reference security’s spot price.³⁰⁶ CDSs do provide valuable informa-

297. See Amendments to Regulation SHO, 74 Fed. Reg. at 38267 n.16.

298. Amendments to Regulation SHO, Exchange Act Release No. 56212, 72 Fed. Reg. 45544, 45544 n.1 (Aug. 14, 2007).

299. *Id.* at 45544.

300. *See id.*

301. See CHOUDHRY, *supra* note 31, at 6–10 (discussing the structure of unfunded credit derivatives, such as credit default swaps).

302. See Short Sales, Exchange Act Release No. 48709, 68 Fed. Reg. 62972, 62975 (Nov. 6, 2003) (“[N]aked short sellers enjoy greater leverage than if they were required to borrow securities and deliver within a reasonable time period, and they may use this additional leverage to engage in trading practices that deliberately depress the price of a security.”).

303. *See id.*

304. See Edward E. Kaufman & Johnny Isakson, Op-Ed., *To Restore Trust in Market, Stop Abusive Short Selling*, ATLANTA J.-CONST., May 5, 2009, http://www.ajc.com/opinion/content/opinion/stories/2009/05/05/isaksoned_0505.html.

305. See Short Sales, 68 Fed. Reg. at 62975.

306. See CHOUDHRY, *supra* note 31, at 9–10 (“The original buyer of the default swap need never have owned a bond issued by the reference asset obligor.”).

tion to the bond market, but they only indirectly affect the spot price of the reference assets.

Additionally, although uncovered CDSs offer leverage to both protection purchasers and sellers, naked short selling offers (theoretically) unlimited leverage, since the seller does not buy or borrow the security.³⁰⁷ Further, amplifying the manipulative potential of naked short selling is the fact that naked short sellers “may use this additional leverage to engage in trading activities that deliberately depress the price of a security.”³⁰⁸

The direct effect of a naked short sale on the market in an underlying security by artificially increasing liquidity in a downward direction provides ample opportunity for market manipulation. In a very typical naked short manipulation case, the SEC brought enforcement action against individuals involved in a manipulative naked short selling scheme.³⁰⁹ In that case, the defendants held convertible bonds in Sedona, a NASDAQ Small Cap company.³¹⁰ At the bondholder’s option, the bonds were convertible into Sedona common stock.³¹¹ The conversion rate was calculated at a discount to the market price of the stock, so the lower the price of the company’s stock, the greater the number of shares the defendant would receive in the conversion.³¹² The SEC alleged that the defendants engaged in “massive naked short selling” of Sedona stock in order to flood the market with the stock, decreasing its price and increasing the number of shares the defendants received in the conversion.³¹³

Unlike naked short selling, CDSs cannot artificially inflate the liquidity of reference assets; trading in CDSs can only directly impact the market in CDSs. While an investor who pushes spreads higher on CDSs can distort the market for the underlying debt by decreasing investors’ trust in the reference entity and increasing debt premiums, such distortion can be counteracted to some extent by transparency measure like those imposed by the Act.

Naked short selling provides the market with some benefits, such as increasing the liquidity of hard-to-locate over-the-counter stocks.³¹⁴

307. See MARK JICKLING, CONG. RESEARCH SERV., RS 22099, REGULATION OF NAKED SHORT SELLING (2005), available at <http://openers.com/document/RS22099/2005-03-30/download/1013/>.

308. Short Sales, 68 Fed. Reg. at 62975.

309. See Rhino Advisors, Inc. & Thomas Badian, Litigation Release No. 18003, 79 SEC Docket 2079 (Feb. 27, 2003).

310. See *id.*

311. See *id.*

312. Short Sales, 68 Fed. Reg. at 62975 n.31.

313. See *id.*; Rhino Advisors, Inc. & Thomas Badian, Litigation Release No. 18003, 79 SEC Docket 2079.

314. See, e.g., Michael Mackenzie, *SEC’s New Short Selling Rules ‘Threaten Liquidity,’* FIN. TIMES, Mar. 2, 2010, <http://www.ft.com/cms/s/0/9c6ca430-262a-11df-aff3-00144feabdc0,s01=1.html> (“Short sales are also undertaken by investors hedging

However, because of naked short selling's high potential for manipulation and its unfairness to counterparties, the ban on naked short selling is probably, on balance, conducive to well-ordered markets. In contrast, although imposition of an insurable interest requirement on CDSs would conceivably limit the potential for market distortion originated in the CDS markets, that benefit is unlikely to outweigh the social and market benefits of trading in uncovered CDSs. Those benefits are considered in the next section in the context of a discussion of the moral hazards and social utility of CDSs as compared to those of insurance policies.

VIII. WHY THE ANALOGY BETWEEN FIRE INSURANCE AND UNCOVERED CDSs FAILS

A. Differences Between Hedging and Insurance

There is a relatively straightforward standard that dictates who is permitted to purchase traditional life or property insurance covering a particular risk—the insurable interest requirement. A person without an insurable interest does not, by definition, have an economic interest in the subject of a policy.³¹⁵ As illustrated in the classic example, a person does not have an economic interest in his neighbor's house; his neighbor's house burning to the ground will not directly affect him in an economic sense.³¹⁶ The insurable interest requirement provides a simple test for determining whether a person is at risk in the insurance context. Determination of whether a protection purchaser has an economic interest in a reference obligation is far more complex. There is no such straight-line demarcation between parties who have an economic interest in a reference entity or its obligations. To require that every person who purchases CDS protection own the CDS's reference obligations would exclude investors who purchase protection for hedging purposes but who do not own the reference obligations.³¹⁷

positions and are used by market makers to keep liquidity flowing across markets.”).

315. See, e.g., Banks McDowell, *Insurable Interest in Property Revisited*, 17 *CAP. U. L. REV.* 165, 171 (1988) (“Insurable interest defines a minimum kind of connection which the purchaser of insurance must have with the subject of the risk in order for the transaction to be valid.”).
316. See, e.g., MILES MENANDER DAWSON, *PRINCIPLES OF INSURANCE LEGISLATION* 3 (New York, Humboldt Library 1895). However, the value of his house may decrease if his neighbor's burned house is not rebuilt.
317. See Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 *FORDHAM J. CORP. & FIN. L.* 167, 189 (2007); see also M. Todd Henderson, *Credit Derivatives are not “Insurance,”* 16 *CONN. INS. L.J.* 1, 32 (2009) (“If (insurance) regulation is limited to cases where there is an insurable interest, the contract is not one of simple hedging,

In the simplest case, a CDS is purchased to hedge against a specific risk in an investor's or institution's portfolio.³¹⁸ A hedge fund may, for instance, own \$100 million in Corporation A's bonds. That risk can be hedged by purchasing CDS protection with a notional amount of \$100 million. In that case, the insurable interest requirement (as applied to CDSs) would be satisfied. However, this oversimplified case does not represent many hedging transactions.³¹⁹ As an example, a U.S. firm may have U.K. interest rate exposure flowing from non-sovereign debt denominated in U.K. pounds and may choose to hedge that interest rate risk by purchasing a CDS on U.K. sovereign debt, even though the firm does not directly hold U.K. sovereign debt. Although many hedging transactions involving the purchase of a CDS would satisfy the insurable interest requirement, some legitimate hedging transactions would not. As a result, application of the insurable interest requirement to credit derivatives would artificially limit hedging opportunities.

B. Distinctions Between Moral Hazards Present in Fire Insurance and Uncovered CDS Positions

The discussion of the application of the insurable interest requirement to CDSs in Part IV concluded that the requirement would reduce or eliminate the manipulative potential of CDSs. Yet, insurance and CDSs present different risk-benefit profiles, and application of insurance concepts to credit derivatives may do more harm than good for the markets and society in general.

The analogy between fire insurance and CDSs first breaks when we compare the respective moral hazards presented by the two. As discussed in Part VI, insurance introduces a moral hazard by encouraging, or at least reducing discouraging side effects of, destructive behavior.³²⁰ Thus, for instance, when a person insures his house against fire damage, he may be more careless when cooking in his house because the economic cost of carelessness has been reduced by the insurance policy.³²¹ This moral hazard is accordingly thought to increase the probability that an adverse event will occur.³²²

The moral hazard introduced by insurance is greater when the party purchasing an insurance policy has no financial interest in the

arbitrage, or speculation, and there is risk pooling, then this class of cases is like an empty set.”).

318. See CHOUDHRY, *supra* note 31, at 2 (“Credit derivatives may be used to manage risk exposure inherent in a corporate or non-AAA sovereign bond portfolio . . .”).

319. See Henderson, *supra* note 317.

320. See discussion *supra* sections VI.A–B.

321. Deborah Stone, *Beyond Moral Hazard: Insurance As Moral Opportunity*, 6 CONN. INS. L.J. 11, 12 (1999).

322. *Id.* at 12 n.1.

insured.³²³ The example of purchasing fire insurance on a neighbor's house is powerful in the CDS context, because anyone can understand the risk to his house if a neighbor—or worse, an enemy—is allowed to purchase insurance on it. A neighbor who purchases a fire insurance policy on the house of another has an economic incentive to see the house burn and no counterbalancing incentive to see it survive.³²⁴ If the house does not burn, the neighbor will be out the premiums paid on the fire insurance policy. However, if the house burns, the neighbor will profit to the extent the policy payout is greater than premiums paid on the policy. Although there are disincentives to burning the house down—criminal and civil liability—from a purely economic standpoint, the neighbor will benefit if the house burns and may be tempted to start a fire himself if desperate enough for the payout and if he believes that his chance of getting caught by the authorities is slim.

Moral hazard can also be thought of as information asymmetry, where a person who has more information about a situation has an incentive to act inappropriately from the perspective of the party who will bear the economic consequences of the risk.³²⁵ The information asymmetry in the fire insurance scenarios relates to the intentions of the person who purchases fire insurance on his neighbor's house. Neither the homeowner nor the insurer know the intentions of the purchaser: Is he simply speculating, intending to hold the policy as a gamble that his neighbor's house will burn? Or, does he intend to take steps to burn his neighbor's house down, thus accelerating his return on the policy? Although an insurer can mitigate or eliminate the moral hazard in the fire insurance scenario by choosing not to issue insurance to a person without an insurable interest in the property insured or constructing a contract that will not pay if the purchaser intentionally causes the risk to materialize, the homeowner is without such power in this situation. As a result, legislatures and courts have seen fit to impose an insurable interest requirement on every purchase of insurance to protect the public from strangers who would purchase insurance policies with bad intentions.³²⁶

323. McDowell, *supra* note 315, at 173 (“In all cases where there is no insurable interest, the moral hazard temptation is clearly present because the insured has no interest to suffer a loss . . .”).

324. *Cf.* ABRAHAM, *supra* note 232, at 7 (explaining that the owner of a life insurance policy purchased on another's life “had an incentive to cause the insured death to occur”).

325. *See generally* Edward Goldstein, *Moral Hazard, Hurricanes, and Climate Change*, 14 GEO. PUB. POL'Y REV. 17 (2009) (“[A]symmetry comes about when the person taking the risk . . . has sufficient information about the risk they are taking, perhaps more than the party paying for the potential negative consequences of the risk . . .”).

326. *See* CAL. INS. CODE § 281 (West 2010); *Warnock v. Davis*, 104 U.S. 775, 778–79 (1881).

The moral hazard presented by CDSs presents a different danger than fire insurance and requires a different regulatory response, because the manipulative power of a protection purchaser is far greater in fire insurance than CDSs. By following through on a simple set of steps, a person can burn down his neighbor's house with near 100% efficacy: he need only walk out his front door, pour a sufficient quantity of gasoline on his neighbor's house, and light a match. Manipulation of a sovereign's or corporation's creditworthiness or capacity to satisfy its debts is a far more complex task requiring capital possessed by only a few, if any, of the world's largest money center banks.

First, information asymmetries in the CDS market are buffered by other market participants; there is no such balance in the case of insurance. As is the case when a person purchases fire insurance on his neighbor's house, the information asymmetry in the purchase of CDS protection involves the intentions of the party purchasing protection. The purchaser may simply be a speculator who believes the creditworthiness of the reference entity is suspect. Or, the purchaser may be purchasing protection as a hedge. Or, the purchaser may have nefarious purposes, intending to manipulate the creditworthiness of the reference entity in order to profit from a secondary sale of the CDS or from a payout triggered by a credit event. Where the information asymmetry differs between insurance and credit derivatives is in the scope of forces balancing the asymmetry. While the insurer may have access to superior information about the purchaser's intentions, the insurer is only a single competing source of information. Thousands of counterparties in the CDS and bond markets participate in countless trades, each of which provides the market with different information about reference entities and obligations. Thus, while the market may be unaware that a substantial CDS trade was made for manipulative purposes, most such trades would be ineffective because competing, contradictory information will balance the information asymmetry.

These competing sources of information balance information asymmetries in the CDS market, which only secondarily affects the bond markets. Purchase of CDS protection cannot directly affect yields on a reference entity's debt. Only the largest financial players would have the wherewithal to manipulate the bond market through CDS trades. Because the moral hazard presented by uncovered CDSs is significantly reduced from that of stranger purchased insurance policies, the insurable interest requirement is the proverbial sledge hammer to the fly representing uncovered credit default swaps. While credit default swaps may precipitate crisis, such as the collapse of AIG, it is not because they present a significant moral hazard.

C. CDSs: Information and Price Discovery

CDSs, covered and uncovered, serve an important social purpose by providing the market—and the public in general—with valuable information about the corporations and governments that are the CDSs' reference entities.³²⁷ A number of empirical studies have demonstrated that price discovery in the CDS markets is superior to that in the bond markets, with the CDS markets “leading” other markets.³²⁸ The “CDS market plays a more important price discovery role than the bond market.”³²⁹

This informational role may be enhanced, in part, because the credit markets provide the public market a glimpse of the banks' information about their customers on whom credit derivatives are being bought and sold.³³⁰ CDS markets may be “transmitting non-public information into publicly traded securities such as stocks,” thus moving private information in the CDS markets into the public markets, increasing information flow in the public markets.³³¹ Concerns are thus raised about insider trading, because, at least in the equity markets, there is good evidence that insider trading and other informational asymmetries may harm market liquidity.³³² Indeed, the prevalence of insider trading in CDS may be more acute because many, or most, of the major players in the credit derivatives markets are insiders.³³³ Yet, although insider trading is taking place in the CDS markets, it is unlikely that such trading negatively affects liquidity or prices in the market.³³⁴ One study found that insider trading may be actually increasing liquidity in the CDS markets.³³⁵

Obviously any blatant attempt at market manipulation carried out using CDSs or short selling does not improve information about an entity or its debt. However, such attempts at manipulation are becoming increasing more difficult as liquidity in a given market increases and the associated increase in market pricing information is

327. See GERALD P. DWYER & THOMAS FLAVIN, CTR. FOR FINANCIAL INNOVATION & STABILITY, FED. RESERVE BANK OF ATLANTA, CREDIT DEFAULT SWAPS ON GOVERNMENT DEBT: MINDLESS SPECULATION? (2010), available at http://www.frbatlanta.org/documents/cenfis/pubscf/nftv_0910.pdf (demonstrating that CDS “spreads reflect fundamental developments, not mindless speculation,” using data from Ireland's recent sovereign debt crisis).

328. See Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110 (2007); Lars Norden & Martin Weber, *The Co-Movement of Credit Default Swap, Bond and Stock Markets: An Empirical Analysis*, 15 EURO. FIN. MGMT. 529 (2009).

329. See Acharya & Johnson, *supra* note 328, at 114.

330. See *id.* at 113.

331. See *id.*

332. *Id.* at 112–13.

333. See *id.* at 111.

334. See *id.* at 138.

335. *Id.* at 138.

made available by diverse market participants. Ironically, a result of broad based restrictions on short selling and CDSs is that the public's information about the health of its foundational entities—corporations and governments—will be compromised by regulation that reduce the number of market participants, which in turn increases the likelihood of future bubbles.

Even if CDSs do speed collapse by applying downward pressure to reference obligations, such effect may simply be the result of a more accurate credit profile being painted of reference entities. As painful as the pinch may be if CDS activity increases yields on a reference entity's debt, this pain may serve as a legitimate warning, signaling trouble and hopefully forcing a response that addresses the problems underlying the pain. Moreover, even if CDSs (and short selling activity) hasten an inevitable downturn, bringing to light credit difficulties of the underlying reference debt issuer more quickly than would have otherwise occurred, they may reduce the aggregate downturn by getting an entity back on track sooner than it would have been if inevitable failure had been delayed.³³⁶

D. Policy Choice

Regulators tackling credit default swaps have a clear policy choice to make. They can choose to believe that the CDS market wags the tail of the underlying spot market for reference debt, necessitating strict restrictions—such as the insurable interest requirement—on uncovered transactions. Under that view, big market players like Goldman Sachs are all-powerful, playing the same game as the penny stock manipulators who use naked short selling to drive down the price of stocks. Imposition of an insurable interest requirement is necessary to curtail speculation in CDSs, and the associated costs—such as decreased liquidity and increased cost-of-debt all around—are outweighed by the benefits of regulating CDSs like insurance.

Regulators can choose instead to recognize that a more nuanced approach is necessitated by the social value provided by CDSs and the detachment of the CDS market from the bond markets. While the insurable interest requirement is an easy solution to the perceived potential for market manipulations or distortion by means of CDSs, the fire insurance analogy is flawed, because allowing a person to purchase fire insurance on his neighbor's house carries all the risk generated by a significant moral hazard and none of the social benefits of uncovered CDSs. In contrast to insurance contracts issued without an insurable interest, uncovered CDSs precipitate a greatly reduced

336. See Philipp Bagus, *The Social Function of Credit-Default Swaps*, INT'L BUS. TIMES (June 29, 2010), <http://www.ibtimes.com/contents/20100629/social-function-credit-default-swaps.htm>.

moral hazard and offer the marketplace and society in general a number of benefits. Uncovered CDSs, for example, contribute a wealth of information to the bond market, enhancing the price discovery process for their reference obligations. In contrast to other market activities—like naked short selling—CDSs, as derivatives, do not allow direct manipulation of their reference obligations. The effect of CDSs on the bond market is indirect, making manipulation of the spot market through CDSs far less likely. Naked short-selling is a far more effective market manipulation tool than CDSs, offering greater leverage and direct access to the market being manipulated. While insurance and short selling both have attributes which make them appealing analogues to CDSs, these analogies break down under a more focused analysis.

IX. CONCLUSION

The efficacy of the Dodd-Frank Wall Street Reform and Consumer Protection Act's reliance on imposed transparency in the CDS markets must be compared with that of current European proposals and New York's prior effort to impose varying degrees of market restrictions on trading in "naked CDSs" as a regulatory tool to curb perceived abuses. If the newly enacted Dodd-Frank legislation is successful in bringing CDS trading out of the shadows, the ensuing enhanced market information should expose any outright attempts at market manipulation. Further, if we look to markets to efficiently determine price or lending rates, the U.S. paradigm of increasing access to information about CDS trades and market participants should prevail over attempts to curtail certain types of market activity. The imperfect fit of the insurable interest requirement to CDS markets should cause concern in light of its limiting constraints on the price discovery function of the market. Requiring market participants to have an interest in the underlying debt will shrink the CDS markets and cause them to price credit risk less efficiently.

The best measure of the contrasting regulatory frameworks will be the degree to which they bar the CDS market from distorting prices in the underlying reference debt. Ultimately it will be left to economists to quantify and measure the degree to which the CDS markets led to or accelerated the implosion of AIG or the market's turn against Greek debt. Absent overwhelming empirical evidence pointing to the CDS markets as the causal determinant of such market implosions, we must hesitate before unduly restricting CDS markets based primarily on popular displeasure with resulting credit markets. The final test of whether market transparency alone can effectively regulate CDS markets will be how much higher the cost of borrowing is between markets that do and do not require an insurable interest in the underlying debt.