

SACRIFICING FUNCTIONALITY FOR TRANSPARENCY? THE REGULATION OF SWAP AGREEMENTS IN THE WAKE OF THE FINANCIAL CRISIS

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INTRODUCTION

Once the sole province of chief executive officers and hedge fund managers, swap agreements (or “swaps”), most notably credit default

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swaps,¹ came to the forefront of politicians' and regulators' minds with the near-collapse of the U.S. financial system in 2008. Having operated largely in the shadows of the lightly regulated over-the-counter (OTC) derivatives market, companies went unimpeded when they sold credit default swaps to cover trillions of dollars in securities and bonds.² Credit default swaps written by American International Group, Inc. (AIG), for instance, covered more than \$440 billion in bonds.³ Unable to cover the contracts' costs when they became due at the onset of the financial crisis, the U.S. government, arguably to save the larger financial system,⁴ bailed out AIG and some of the largest financial institutions in the world.⁵

In response, and in an effort to gain control over the opaque OTC derivatives market, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010, which, in part, provided authorization to both the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) to regulate swap agreements.⁶ Acting on its congressional

1. For a more in-depth discussion of credit-default swaps, *see infra* Part I.A.1.b.

2. *See* MARCO AVELLANEDA & RAMA CONT, INT'L SWAPS & DERIVATIVES ASS'N, TRANSPARENCY IN CREDIT DEFAULT SWAP MARKETS 8 (July 2010), *available at* http://www.isda.org/c_and_a/pdf/CDSMarketTransparency.pdf ("In 1997, the notional open interest in [credit default swaps] was on the order of 200 billion dollars; by 2007 it had grown to approximately USD 60 trillion.").

3. Adam Davidson, *How AIG Fell Apart*, REUTERS (Sept. 18, 2008), <http://www.reuters.com/assets/print?aid=USMAR85972720080918>.

4. *Cf.* HENRY M. PAULSON JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM 99 (2010) ("A Bear Stearns failure wouldn't just hurt the owners of its shares and its bonds. Bear had hundreds, maybe thousands, of counterparties—firms that lent it money or with which it traded stocks, bonds, mortgages, and other securities. These firms . . . all in turn had myriad counterparties of their own. If Bear fell, all these counterparties would be scrambling to collect their loans and collateral. . . . That was how bank runs started these days.").

5. *See, e.g.*, Steven M. Davidoff, *Uncomfortable Embrace: Federal Corporate Ownership in the Midst of the Financial Crisis*, 95 MINN. L. REV. 1733, 1737-44, 1754-55 (2011) (discussing the U.S. government's assistance to AIG, Citigroup, and Bank of America); Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL STREET J. ONLINE (Sept. 16, 2008), <http://online.wsj.com/article/SB122156561931242905.html> (reporting on the U.S. government's bailout of AIG).

6. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 762, 124 Stat. 1376, 1759 (2010). Interestingly, save for section 10(b) of the Securities Exchange Act of 1934, *see* Commodity Futures Modernization Act, Pub. L. 106-554, § 303(d), 114 Stat. 2763, 2763A-454 (2000) (providing for the regulation of swap agreements under section 10(b)); *see also* Caiola v. Citibank, 295 F.3d 312, 327 (2d Cir. 2002) ("Sections 302 and 303 of the [Commodity Futures Modernization Act] define 'swap agreements' and then expressly exclude them from the definition of 'securities,' but amend section 10(b) to reach swap agreements."). Swap agreements were expressly exempted

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mandate, the SEC in early 2011 released for public comment Regulation SB SEF,⁷ which purports to remove many swap agreements from the OTC market and put them on exchanges or swap execution facilities, and thereby inject greater transparency into the OTC derivatives market.

This Article argues that Regulation SB SEF does not adequately consider the fundamental differences between securities and swap agreements that render swap agreements less amenable to securities-like exchanges. Part I of this Article defines what a swap agreement is and describes the SEC's attempt to regulate them. Part II dissects the case for regulating swap agreements and analyzes their fundamentals in order to better understand how to regulate them. Part III suggests an alternative regulatory structure that will better allow the swaps market to function.

I. SWAP AGREEMENTS AND THE SEC'S EFFORTS AT REGULATING THEM

After the Great Recession of 2008, Congress and the SEC turned their sights on the alleged "monster"⁸ of the financial crisis: swap agreements. Having reached a notional amount outstanding⁹ of \$583 trillion at the end of June 2010,¹⁰ the government is right to question the prudence of allowing such a market to continue to expand without appropriate checks. Nevertheless, many U.S. citizens do not understand swaps, the market in which they currently trade, and the government's efforts at regulating them. Thus, this Part seeks to provide greater clarity to the debate by providing examples of the most common types of swap agreements and outlines the SEC's most recent attempts at regulating them.

from regulation in the Securities Exchange Act of 1934. 15 U.S.C. § 78c-1(a)-(b) (2006).

7. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948 (proposed Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242, 249).

8. See Matthew Philips, *The Monster That Ate Wall Street: How 'Credit Default Swaps'—an Insurance Against Bad Loans—Turned from a Smart Bet into a Killer*, NEWSWEEK.COM (Sept. 26, 2008, 8:00 PM), <http://www.newsweek.com/2008/09/26/the-monster-that-ate-wall-street.html>.

9. "Notional amounts outstanding" refer to "the gross nominal or notional value of all deals concluded and not yet settled on the reporting date." BANK FOR INT'L SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2008, 5 (May 2009), available at http://www.bis.org/publ/otc_hy0905.pdf. "[Notional] amounts outstanding provide a measure of market size and a reference from which contractual payments are determined in derivatives markets." *Id.*

10. BANK FOR INT'L SETTLEMENTS, TRIENNIAL AND SEMIANNUAL SURVEYS: POSITIONS IN GLOBAL OVER-THE-COUNTER (OTC) DERIVATIVES AT END-JUNE 2010 2 (Nov. 2010), available at http://www.bis.org/publ/otc_hy1011.pdf.

A. *Understanding and Defining Swaps and the Swaps Market*

Though swap agreements have only recently come into public view, many laypersons do not understand what swap agreements are or why their use is so opaque. This section, therefore, attempts to shed light on swap agreements and the market in which they trade in two parts. First, it looks at swap agreements broadly and then outlines two specific types—an interest rate swap and a credit default swap—to better see the myriad ways financial institutions employ them. Second, this section discusses the OTC derivatives market in which the vast majority of swap agreements currently trade.

1. *Defining Swap Agreements*

In its most basic sense, a “swap is a contractual agreement evidenced by a single document in which two parties, called counterparties, agree to make periodic payments to each other.”¹¹ Designed, in part, to hedge against risk, swaps allow institutions to identify and isolate risks associated with particular financial portfolios.¹² Risk, however, can stem from many sources. Therefore, financial engineers have developed numerous types of swaps to address individual institutions’ unique concerns.¹³ To better understand swaps, it is thus useful to briefly outline two of the most recognized kinds: interest rate swaps and credit default swaps.

A. *Interest Rate Swaps*

“Interest rate swaps are the most popular type of swap transaction[s].”¹⁴ The simplest type of interest rate swap is called the “plain vanilla” interest rate swap¹⁵ or a “fixed-for-floating” interest rate swap,¹⁶ “which consists of one counterparty making a fixed-rate

11. JOHN F. MARSHALL & KENNETH R. KAPNER, UNDERSTANDING SWAPS 3 (1993) (emphasis omitted); *see also* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 206(b), 113 Stat. 1393, 1394 (1999) (defining “swap agreement” more specifically to mean “any individually negotiated contract, agreement, warrant, note, or option that is based in whole or in part, on the value of any interest in, or quantitative measure or occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices”).

12. Willa E. Gibson, *Are Swap Agreements Securities or Futures? The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. CORP. L. 379, 380 (1999).

13. Swap agreements “are tailor-made to meet the needs of the individual counterparties.” MARSHALL & KAPNER, *supra* note 11, at 3. I address this point later in this Article. *See infra* Part II.B.1.

14. Gibson, *supra* note 12, at 384.

15. *Id.*

16. MARSHALL & KAPNER, *supra* note 11, at 3.

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payment to the second counterparty, who in exchange makes a floating-rate payment to the first counterparty.”¹⁷ More concretely, take, for example,¹⁸ two entities: a savings and loan (“S&L”) with variable-rate liabilities in the form of savings and deposits and a commercial bank (“bank”) with variable-rate assets in the form of loans. The S&L will want to hedge against an upward rise in interest rates, which would result in it having to pay additional amounts to its depositors. Accordingly, the S&L will want to receive variable-rate payments. In contrast, the bank will want to hedge against a decline in interest rates, which would result in it receiving less income from its loans, as they are variable. Thus, both parties can gain from the other by entering into a swap transaction: the S&L pays fixed-rate payments to the bank (which covers the bank’s variable-rate assets) and the bank pays variable-rate payments to the S&L (which covers the S&L’s variable-rate liabilities).

As shown, institutions utilize the interest rate swap to hedge against an increase or decrease in interest rates. Credit default swaps, however, take on a very different form.

B. Credit Default Swaps

Invented by Wall Street in the 1990s “to make it easier for banks to issue complex debt securities by reducing the risk to purchasers,”¹⁹ credit default swaps operate very much like a standard insurance contract,²⁰ except that the insurance is against a default of a security, bond, or the like,²¹ as opposed to the occurrence of a hurricane, fire, and so on. At its most basic, then, “a credit default swap is a promise by one party to pay another party in the event that a third party defaults.”²² A credit default swap transaction thus takes the following form: a buyer (the seller of credit risk)²³ enters into a contract with a seller (the buyer

17. Gibson, *supra* note 12, at 384.

18. This example is adapted from Professor Willa Gibson’s article. *See id.* at 384-85.

19. Times Topics, *Credit Default Swaps*, N.Y. TIMES ONLINE (Apr. 29, 2011), http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_default_swaps/index.html.

20. *Id.*

21. *See, e.g.,* Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME.COM (Mar. 17, 2008), <http://www.time.com/time/printout/0,8816,1723152,00.html> (“Credit default swaps are insurance-like contracts that promise to cover losses on certain securities in the event of a default. They typically apply to municipal bonds, corporate debt and mortgage securities and are sold by banks, hedge funds and others.”).

22. Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 52 (2011).

23. *See* FICC CREDIT STRATEGIES, GOLDMAN SACHS, CDS 101: CREDIT DERIVATIVES 7 (Oct. 2009), available at <http://www2.goldmansachs.com/media-relations/comments-and->

of credit risk)²⁴ to protect against the default of a particular bond, of which the buyer owns \$1 million worth. Over the life of the contract,²⁵ the buyer pays a premium until the bonds default or the contract term lapses.²⁶ If, however, the bonds do default, the seller is obligated to pay the buyer \$1 million, or the total amount of bonds that the buyer had “insured.”

Credit default swaps can be beneficial when used appropriately.²⁷ The issue, however, is that unlike standard insurance, the credit default swap market and the swap market generally is almost entirely unregulated.²⁸ Rather, both operate in the so-called “Wild West” of financial markets: the OTC derivatives market.²⁹

2. *An Overview of the Over-the-Counter Derivatives Market*

The OTC derivatives market, also known as the OTC swaps market,³⁰ is a service that caters to a broad array of investors: Fortune 500 companies, banks, insurance companies, asset managers, hedge funds, and even public entities such as sovereign-wealth funds and public-sector pension funds.³¹ And in the investors it serves, the OTC market is not substantially different from a national securities exchange. Both cater to and effect transactions on behalf of institutions, both financial and otherwise. Where it does differ is the degree of

responses/archive/state-of-the-market-cds-101.pdf (identifying the “protection buyer” as the “seller of credit risk”).

24. *Id.* (identifying the “protection seller” as the “buyer of credit risk”).

25. The standard term of a credit-default swap contract is five years. See Nicholas Varcharver & Katie Benner, *The \$55 Trillion Question*, CNNMONEY.COM (Sept. 30, 2008, 12:28 PM), http://money.cnn.com/2008/09/29/magazines/fortune/varcharver_derivatives.fortune/index.htm (“Many technical aspects of [credit default swaps], such as the typical five-year term, have been standardized by the International Swaps and Derivatives Association (ISDA).”).

26. “The greater the perceived likelihood of . . . default, the higher the premium [the seller] will demand from [the buyer].” Kress, *supra* note 22, at 52.

27. For a discussion of some of the benefits associated with credit-default swaps, see Christopher Cox, Opinion, *Swapping Secrecy for Transparency*, N.Y. TIMES ONLINE (Oct. 19, 2008), <http://www.nytimes.com/2008/10/19/opinion/19cox.html> (arguing that credit default swaps “play an important role in the smooth functioning of capital markets by allowing a broad range of institutional investors to manage credit risks to which they are exposed. They are also a useful means for investors to signal their view of an entity’s business prospects and creditworthiness.”).

28. See *Credit Default Swaps*, *supra* note 19.

29. See Colleen M. Baker, *Regulating the Invisible: The Case of Over-the-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1298 (2010).

30. *Id.* at 1297 (“Exchange-traded derivatives are sometimes generically referred to as ‘futures.’ Similarly, OTC derivatives are often generically termed ‘swaps.’” (citations omitted)).

31. See AVELLANEDA & CONT, *supra* note 2, at 4.

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transparency that accompanies those transactions.

In a national securities exchange, transactions are executed by “electronic trading platforms that automatically match the bids and offers from market participants to execute trades in a multilateral environment.”³² Moreover, transactions completed on national exchanges are centralized, standardized, and, most importantly for the purposes of this Article, nonconfidential.³³ Swaps in the OTC market, by contrast, are negotiated bilaterally in a largely confidential, decentralized system that includes many instruments that are nonstandardized.³⁴ In this bilateral environment, the terms of contracts are negotiated between a buyer and a seller independently, without the facilitation of an exchange.³⁵ Accordingly, the OTC market, unlike national exchanges, does not always use electronic media to facilitate and execute trades.³⁶ Rather, such use varies across OTC trading venues, “with some venues being highly electronic whereas others rely almost exclusively on non-electronic means such as telephone.”³⁷

Despite its arguable shortcomings in the way of confidentiality, the OTC derivatives market has flourished over the years. The Bank for International Settlements’ recent survey found that the OTC derivatives market achieved a notional amount outstanding of roughly \$583 trillion at the end of June 2010, which was an increase of fifteen percent from 2007,³⁸ though this represents only five percent growth annually, compared to thirty-two percent annual growth from 2004 to 2007.³⁹ The onset of the financial crisis in 2008 resulted in some markets seeing negative growth, having yet to regain their early 2008, pre-financial crisis levels.⁴⁰ In addition, the OTC credit default swaps market, the

32. Randall Dodd, *The Structure of OTC Derivatives Markets*, 9 FINANCIER 1, 1 (2002), available at <http://www.financialpolicy.org/dscotcstructure.pdf>.

33. See generally, *NYSE Rules*, NYSE, <http://nyserules.nyse.com/nyse/> (last visited Jan. 20, 2012) (detailing, in part, the disclosure rules necessary to list on the NYSE and its operating procedures).

34. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948, 10,951 (proposed Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242, 249).

35. Kress, *supra* note 22, at 54.

36. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. at 10,951.

37. *Id.*

38. See BANK FOR INT’L SETTLEMENTS, *supra* note 10.

39. *Id.*

40. See, e.g., *Dow Jones Industrial Average (2000-Present Daily)*, STOCKCHARTS.COM, <http://stockcharts.com/charts/historical/djia2000.html> (last visited Jan. 14, 2012) (identifying the Dow’s index in April 2008 as 12,820.13 and its index in the first quarter of 2011 as 12,226.34).

alleged boogeyman of the financial crisis,⁴¹ also grew exponentially. From 2002 until 2007, the size of the credit default swaps market exploded from \$1.6 trillion in mid-2002 to its peak of \$62.2 trillion in 2007,⁴² “more than the gross domestic product of all nations on earth combined.”⁴³ And though the 2008 financial crisis caused that number to decline to \$26.3 trillion in mid-2010,⁴⁴ that number is still roughly “double the entire United States stock market capitalization.”⁴⁵

Though some may tout the growth of the OTC derivatives market as a sign of a healthy market, others grow increasingly concerned about its lack of transparency. The U.S. government, after all, bailed out AIG because of its exposure in the credit default swaps market that no regulator fully understood.⁴⁶ Thus, to establish greater transparency in the swaps market, Congress in Dodd-Frank authorized the SEC to regulate swap agreements.⁴⁷ In response, the SEC promulgated proposed Regulation SB SEF, which seeks, in part, to remove many swap agreements from the OTC market and place them in national exchanges, and thereby bring greater transparency to the swaps market.

B. Regulation SB SEF: The SEC’s Proposed Rule to Regulate Swap Agreements

Acting on the authority Congress gave it in Dodd-Frank,⁴⁸ the SEC on February 28, 2011 released for comment proposed Regulation SB SEF.⁴⁹ Congress, however, did not provide the SEC with exclusive authority to regulate swaps; rather, Congress allocated the regulatory authority as such: the CFTC will regulate swaps,⁵⁰ the SEC will regulate security-based swaps,⁵¹ and the SEC and the CFTC will jointly regulate

41. See, e.g., Philips, *supra* note 8 (questioning “[h]ow ‘credit defaults swaps’—an insurance against bad loans—turned from a smart bet into a killer”).

42. *Summaries of Market Survey Results*, INT’L SWAPS & DERIVATIVES ASS’N, <http://www.isda.org/statistics/recent.html> (last visited Jan. 14, 2012); see also Kress, *supra* note 22, at 54 (commenting on the same data).

43. Cox, *supra* note 27.

44. *Summaries of Market Survey Results*, *supra* note 42.

45. Kress, *supra* note 22, at 54.

46. Varcharver & Benner, *supra* note 25 (discussing AIG and its credit default swaps contracts).

47. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 762, 124 Stat. 1376, 1759 (2010).

48. *Id.*

49. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948 (proposed Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242, 249).

50. Dodd-Frank Wall Street Reform and Consumer Protection Act § 712(a)(1).

51. *Id.* § 712(a)(2).

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mixed swaps.⁵² The SEC's and the CFTC's proposed regulations are substantially similar, however, so this Article, though referring to the SEC's regulation, will reference swaps generally, as opposed to security-based swaps that are within the SEC's congressionally authorized purview.

Regulation SB SEF, at a minimum, is "designed to create a registration framework for security-based swap execution facilities."⁵³ More specifically, the SEC's regulation attempts to do three things: (1) establish a framework that mandates parties to clear their swaps transactions through a clearing agency if the transactions are of the type the SEC concludes these parties must clear; (2) establish the rule that if the swap is subject to the clearing requirement, the parties must execute it on an exchange or on a swap execution facility registered under section 3D of the Securities Exchange Act of 1934; and (3) require parties executing swap transactions to report to a registered swap data repository or the SEC.⁵⁴ In executing these goals, the SEC emphasized the importance of keeping in mind one of the key goals of Dodd-Frank: to bring the trading of swaps onto regulated markets, and thereby reduce the uncertainty and lack of transparency inherent in the OTC derivatives market.⁵⁵

Swap execution facilities and swap exchanges, the SEC maintains, "should help further [Dodd-Frank's] statutory objective of greater transparency and a more competitive environment for the trading of . . . swaps by providing a venue for multiple parties to execute trades in . . . swaps and also by serving as a conduit for information regarding trading interest in . . . swaps."⁵⁶ The SEC intends that these facilities, therefore, will serve an important, if not vital, role in removing transactions in swaps from the opaque OTC derivatives market.⁵⁷

In advocating for the regulation of swaps on exchanges and swap execution facilities, the SEC neglects to expressly define what a swap execution facility may look like. Instead, the SEC offers "baseline

52. *Id.* § 712(a)(8). Though outside the scope of this Article, a real concern is the ability of the SEC and the CFTC to jointly regulate mixed swaps. For a discussion of jurisdictional problems between the SEC and the CFTC, see Gibson, *supra* note 12, at 388-93.

53. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. at 10,948.

54. *Id.* at 10,949.

55. *See id.* at 10,948.

56. *Id.* at 10,949.

57. *Id.*

principles” to interpret the definition of such a facility.⁵⁸ These principles envision a facility that is open to multiple participants who “have the ability to execute or trade . . . swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce.”⁵⁹ The SEC understands the “multiple participants” language to require that any particular trading platform include “at least a basic functionality to allow any participant” to permit any other participant on the same platform to “make and display executable bids or offers accessible to all other participants.”⁶⁰ As an example, the SEC acknowledges that a platform with a single dealer interacting with multiple parties would not appear to meet the “multiple participants” language.⁶¹ These principles, the SEC argues, would provide increased transparency beyond that found in the bilateral operation of the OTC derivatives market.⁶²

Despite Congress’ and the SEC’s efforts to regulate swap agreements through exchanges or swap execution facilities, the question still remains whether the government should regulate swap agreements at all. And, if the government should regulate them, it is unclear whether the unique characteristics of swap agreements render them incapable of regulation on exchanges or swap execution facilities. In light of this, Part II examines the case for regulating swap agreements and whether swap agreements are amenable to regulation as proposed by the SEC.

II. THE CASE FOR REGULATING SWAP AGREEMENTS AND THEIR AMENABILITY TO TRADE ON SECURITIES-LIKE EXCHANGES

The 2008 financial crisis exposed the holes in the United States financial system. Whether it was the 1999 legislative repeal of Glass-Steagall’s division of banking and investment banking⁶³ or the lack of oversight by some of the largest corporate boards in the United States,⁶⁴

58. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. at 10,953.

59. *Id.*

60. *Id.* at 10,954.

61. *Id.*

62. *Id.*

63. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101(a), 113 Stat. 1338, 1341 (1999); see also generally Jerry W. Markham, *The Subprime Crisis—A Test Match for the Bankers: Glass-Steagall vs. Gramm-Leach-Bliley*, 12 U. PA. J. BUS. L. 1081 (2010) (discussing the Gramm-Leach-Bliley Act’s repeal of Glass-Steagall and the attendant ramifications).

64. See, e.g., Reed T. Schuster, *Rule 14a-11 and the Administrative Procedure Act*:

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that the United States' financial system is and was in need of reform is apparent. However, reform, though a convenient political talking point, should not be completed without serious consideration of the pros and cons that would attend such measures. Thus, this Part attempts to establish that nexus for the regulation of swap agreements. First, this Part analyzes the argument for regulating swap agreements and argues that such regulation is not only necessary, but a prudent measure based on the secrecy within which the swaps market currently function. And second, this Part contends that, though increased regulation is necessary, the SEC's proposed regulation sacrifices functionality for transparency, and threatens to undermine the swaps market as a whole.

A. The Case for Regulating Swap Agreements

Some contend that the first currency swap was written in London in 1979⁶⁵ as a way to circumvent foreign-exchange controls.⁶⁶ From that single transaction, the swaps market has grown substantially over the years to a gross market value of \$24.673 trillion, or notional amounts outstanding of \$582.655 trillion.⁶⁷ However, the concern is not necessarily the dollar value of the swaps market on its own, but it coupled with two other characteristics of the market. First, many commentators have expressed concern over the intense secrecy in which the participants of the OTC derivatives market conduct business. And second, the potential for "systemic risk" in the OTC market has been a repeated complaint since before the financial crisis.⁶⁸ As was made clear in the near-collapse of AIG, the swaps market has resulted in an increased interconnectedness of some of the world's largest financial institutions. In effect, the decline of one, scholars argue, could mean the related downfall of others.

First, despite the ever-increasing size of the market for swaps, it has largely operated in the shadows since its inception.⁶⁹ Unlike securities exchanges, in which market participants execute bids and offers from different market participants in a multilateral, non-

It's Better to Have Had and Waived, than to Never Have Had at All, 95 MINN. L. REV. 1034, 1050–55 (2011) (making the case for increased shareholder rights based both on the ever-increasing divide between ownership and control of America's largest corporations and the boards' failures to adequately monitor their corporations leading up to the financial crisis).

65. MARSHALL & KAPNER, *supra* note 11, at 5.

66. *Id.* at 4.

67. See BANK FOR INT'L SETTLEMENTS, *supra* note 10, at 13.

68. See, e.g., Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 368–73 (discussing the potential for systemic risk in the OTC market).

69. See Cox, *supra* note 27.

confidential environment,⁷⁰ transactions on the OTC derivatives market are almost exclusively done bilaterally, in which prices, both bids and offers, are only known by the parties privy to any particular transaction.⁷¹ As such, the price of any particular swap transaction is opaque to parties outside that transaction.

Admittedly, there are certain benefits to the secrecy surrounding the OTC derivatives market. For instance, such secrecy would lend well to its dealer-operated nature. Without the transparency associated with a securities-like exchange, dealers are better able to execute transactions without reference to the end-price of similar or identical transactions.⁷² In effect, the OTC's "market makers" (i.e., dealers) would have an incentive to continue to conduct business in the market and the benefits of the swaps market would continue to accrue.⁷³ On the other hand, there are arguably more significant costs associated with such secrecy. For example, the opaqueness of the OTC derivatives market prevents other participants from knowing what their counterparties' exposure is, which can, and did, result "in mistrust and the drying up of liquidity in the inter-bank money market."⁷⁴ Additionally, the lack of transparency in the OTC market inhibited regulators' ability to identify and respond to risks that had built up in the market.⁷⁵ In consequence, aspects of the financial crisis were as much a surprise to the federal government as it was to the public.⁷⁶

70. See Dodd, *supra* note 32, at 1.

71. *Ensuring Efficient, Safe and Sound Derivatives Markets* 4 (Comm'n of the European Cmty's.) (Mar. 7, 2009), available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf [hereinafter Commission Working Paper].

72. *Contra* Dodd, *supra* note 32, at 2, in which he argues:

Dealers [in the OTC deviates market] have direct phone lines between themselves and other dealers and their major customers, and this enables instantaneous communication so that a market participant can call up a dealer ask for quotes and then hang up and call another so as to survey several dealers in just a few seconds. A quick series of such calls can give an investor a view of the market that is not entirely different from a view obtained by observing a multilateral negotiating process.

That may be true, but when the market "remains dominated by a small number of dealers," the number of opposing viewpoints is likely not many. Gary Gensler, Chairman, Commodity Futures Trading Comm'n, Remarks at George Washington School of Law Regarding Implementation of The Dodd-Frank Act (Jan. 14, 2011), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-65>.

73. See Cox, *supra* note 27 ("[Swaps] play an important role in the smooth functioning of capital markets by allowing a broad range of institutional investors to manage credit risks to which they are exposed. They are also a useful means for investors to signal their view of an entity's business prospects and creditworthiness.").

74. Commission Working Paper, *supra* note 71, at 5.

75. See *id.*

76. Compare PAULSON, *supra* note 4, at 43 ("In August 2006, . . . [t]he economic

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Thus, the lack of transparency associated with the OTC derivatives market, though providing some benefit to the dealers, seemingly played a significant part in the onset of the financial crisis.

Second, some commentators have expressed dismay over the interconnected network of counterparties that the OTC derivatives market has fostered. The concern stems from the “systemic risk” theory: “the danger that the collapse of a major dealer or end-user could have a ‘domino effect’ leading to widespread failures of financial institutions, a loss of investor confidence, and a generalized crisis in the financial markets.”⁷⁷ And as many, if not all, of the chief financial institutions participate in many aspects of the OTC derivatives market, the degree of interconnection between these entities is extremely high, which exacerbates the “domino effect” associated with the failure of one of those institutions.⁷⁸

The concern is not solely with respect to the participants in the derivatives market, but also with regards to the OTC market’s connection to other markets. The markets for securities, bonds, and options, for instance, are closely tied to the OTC market for derivatives.⁷⁹ Whether one points to the near-collapse of Long-Term Capital Management in 1998⁸⁰ or the more recent financial crisis, examples abound of the deleterious effect the OTC derivatives market can have on its sister markets.⁸¹

The opaque nature of the OTC derivatives market and the interconnection between some of the world’s largest financial institutions certainly suggest a need for regulatory oversight.⁸²

outlook was strong. Stocks were trading just below their near-record highs of May. The dollar had shown some weakness . . . but overall the economy was humming . . .”), *with id.* at 61 (commenting that the financial crisis “came from an area we hadn’t expected—housing—and the damage it caused was much deeper and much longer lasting than any of us could have imagined”).

77. Wilmarth, *supra* note 68, at 368. In hindsight, this statement appears eerily prophetic.

78. See Commission Working Paper, *supra* note 71, at 4.

79. See Wilmarth, *supra* note 68, at 368.

80. See, e.g., Mark J. Roe, *The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 587 (2011) (discussing the “fast-moving Russian exchange rates” that “brought down Long-Term Capital Management and its Nobel Prize-winning managers”). For an excellent book on the life and decline of Long-Term Capital Management, see generally ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2000).

81. See Wilmarth, *supra* note 68, at 368 (commenting on the ramifications of Russia’s debt default, the 1987 stock market crash, and the near-collapse of Long-Term Capital Management).

82. See Commission Working Paper, *supra* note 71, at 4.

However, it is also important to keep in mind the costs associated with any new regulatory scheme. As swaps allow a broad swath of institutions to manage credit risk, it is important that such measures do not impede the proper functioning of its market. As the next section contends, Regulation SB SEF does not provide adequate consideration of the fragility in the swaps market.

B. The Differences Between Swap Agreements and Securities Necessitate a Different Approach and Trading Platform from Securities

Common in the arguments urging for greater transparency in the OTC derivatives market is that greater transparency leads both to the proper functioning of the market and increased levels of liquidity.⁸³ In Regulation SB SEF, the SEC contends that to inject greater transparency into the swaps market, swap agreements should be placed on exchanges or multilateral trading platforms.⁸⁴ Unfortunately, the benefits that often accompany securities on exchanges may not correspond to the swaps market. This section discusses two aspects of swap agreements that render them less amenable to national exchanges than securities. First, many swaps agreements, unlike securities, are tailor-made to the needs and wants of the particular transaction's counterparties. Second, swap agreements are inherently less liquid than securities.

1. The Nonstandardized Character of Swap Agreements

Exchanges, such as the New York Stock Exchange, provide a venue for the buying and selling of highly standardized goods.⁸⁵ The exchange provides companies' securities⁸⁶ in a highly transparent system regulated by at least one government agency and the exchange's own rules.⁸⁷ The price of the security shifts, but its underlying terms remain the same. The process is effective, at least in part, because the security's terms are static, and the buyer and seller need not tailor the security to execute the transaction. The buyer accepts the terms of the contract and the price, or she does not. As such, an exchange works to facilitate the transaction for both the buyer and the seller.

83. AVELLANEDA & CONT, *supra* note 2, at 3.

84. Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948, 10,949 (proposed Feb. 28, 2011) (to be codified at 17 C.F.R. pts. 240, 242, 249).

85. See, e.g., James Grimmelmann, Note, *Regulation by Software*, 114 YALE L.J. 1719, 1748 (2005).

86. Bonds, futures, options, etc. are also bought and sold on exchanges.

87. See, e.g., *NYSE Rules*, *supra* note 33.

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In contrast, in many swaps agreements, it is often the case that one counterparty will not want to take the exact opposite position of the other counterparty.⁸⁸ Moreover, it is rare for counterparties with similar needs to put forward their interest in a deal at the same time.⁸⁹ It is therefore the job of swap specialists to not only match the counterparties looking for the exact opposite sides of a deal, but also to then tailor the swap agreement to the particular needs of the two counterparties.⁹⁰ Thus, many swap agreements—though not all⁹¹—are tailor-made.⁹² Whether the transaction is to secure a fixed-rate payment versus a variable-rate payment⁹³ or to insure against the default of a particular bond or security,⁹⁴ many swap agreements do not come standardized and are thus not bought and sold based solely on their posted price. Therefore, unlike standard contracts like securities, swap agreements are not conducive to trade on an exchange.

2. *The Inherent Illiquidity of the Swaps Market*

Generally understood, liquidity is a “measure of the ability to buy or sell a product in a desired quantity and at a desired price and time without materially impacting the product’s price.”⁹⁵ In a market of the highest degree of liquidity, in any particular transaction a buyer can buy or sell a product at its desired quantity and price with little to no impact on the price of the product.⁹⁶ In further determining a market’s liquidity, there are two commonly identified dimensions: participant characteristics and transaction characteristics.⁹⁷ Within those elements, time (“the possibility of buying or selling when the trader wishes to do so”⁹⁸) is also an important consideration. As the following discussion of those two characteristics demonstrates, the OTC derivatives market is not a liquid market and the requirements in Regulation SB SEF threaten

88. See Gibson, *supra* note 12, at 382.

89. See *id.*

90. MARSHALL & KAPNER, *supra* note 11, at 3-4.

91. Standardized swaps do exist and should be put on and regulated through exchange-like trading platforms. This Article, however, is concerned with the large number of swaps that are nonstandardized and would thus be difficult, if at all possible, to subject to securities-like exchanges.

92. See MARSHALL & KAPNER, *supra* note 11, at 3-4.

93. See *supra* Part I.A.1.a.

94. See *supra* Part I.A.1.b.

95. TECHNICAL COMM. OF THE INT’L ORG. OF SEC. COMM’NS, REPORT ON TRADING OF OTC DERIVATIVES 25 (Feb. 2011).

96. *Id.*

97. *Id.* at 27-28.

98. *Id.* at 25.

to cause the already illiquid market to become even less accessible.

First, in any market, the number of market participants is a material factor in determining prospective liquidity.⁹⁹ Exchange-traded futures and equity markets normally have thousands of active participants, “including both liquidity providers and liquidity takers.”¹⁰⁰ For instance, the e-Mini S&P futures (“e-Mini”) exchange, the most successful equity index futures contract in the world,¹⁰¹ has more than 150,000 active participants.¹⁰² Moreover, a less successful futures index, the West Texas Intermediate (WTI) futures contract, a type of crude oil futures index used as a benchmark in oil pricing, has more than 20,000 active participants.¹⁰³ In contrast, the swaps market has a significantly smaller number. For example, the number of active participants in the plain vanilla interest rate swaps, the most popular type of swap transaction,¹⁰⁴ is 510.¹⁰⁵ In the single-name credit default swap market, the number is a mere 220.¹⁰⁶ Thus, the swaps market, in comparison to some futures contracts, contains a significantly smaller number of active participants.

Second, a market’s products’ characteristics, or the ratio of the number of active participants in the market to the number of instruments available, are also indicative of prospective liquidity.¹⁰⁷ The e-Mini futures have an estimated 150,000 participants and five total instruments, thus giving it a rough ratio of 30,000 participants for every one instrument.¹⁰⁸ Though again lower, the WTI futures, with approximately 20,000 active participants and seventy total instruments, has an approximate ratio of 285 active participants for every one instrument.¹⁰⁹ In comparison, the plain vanilla interest rate swaps, with 510 active participants and around 100,000 total instruments, has a ratio

99. *Id.* at 27.

100. TECHNICAL COMM. OF THE INT’L ORG. OF SEC. COMM’NS, *supra* note 95, at 27.

101. E-MINI DAY TRADING, <http://www.eminidaytrading.com> (last visited Jan. 14, 2012).

102. J.P. MORGAN CHASE & CO., OBSERVATIONS ON THE OTC DERIVATIVES MARKET 6 (2010), *attached to* Memorandum from Kathleen Casey, Comm’r, Sec. & Exch. Comm’n, to file (Aug. 11, 2010), *available at* <http://www.sec.gov/comments/df-title-vii/mandatory-facilities/mandatoryfacilities-3.pdf>.

103. *Id.*

104. *See* Gibson, *supra* note 12, at 384 and accompanying text.

105. J.P. MORGAN CHASE & CO., *supra* note 102, at 6.

106. *Id.*

107. TECHNICAL COMM. OF THE INT’L ORG. OF SEC. COMM’NS, *supra* note 95, at 28.

108. J.P. MORGAN CHASE & CO., *supra* note 102, at 6.

109. *Id.*

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of about 0.005 active participants for every one instrument;¹¹⁰ the single-name credit default swaps market has 220 active participants with 83,000 total instruments, giving it a ratio of 0.003 participants for every one instrument.¹¹¹ Therefore, like the participant characteristics, the product characteristics for swaps show a much lower ratio of participants to instruments than some of the futures markets.

Based on these two characteristics, one would expect the prospective liquidity in the swaps market to be highly illiquid. These characteristics will have problematic consequences for the time and size dimensions discussed above. With regard to time—the ability to buy or sell a product when a trader wishes to do so—with so many instruments and so few active participants, it is conceivable that a trader would be unable to buy or sell a particular swap at a time of her choosing, or even within a relatively short period of time. Thus, the prospective liquidity of the swaps market, by all accounts, is not highly liquid, but rather displays characteristics of a minimally liquid market.

But why does liquidity matter? Cleary Gottlieb partner Edward J. Rosen cautioned in a letter to the SEC that the agency “must take care to ensure” that the requirements imposed through Regulation SB SEF “do not unduly interfere with the efficiency of the [swap] market itself or create disincentives to the use of [swap execution facilities] (where swap counterparties have a choice).”¹¹² There are two factors that suggest that imposing an exchange requirement on all swaps transactions will have deleterious effects on the system and result in the “disincentives” Mr. Rosen referenced. First, there is no “retail” component in the swaps market.¹¹³ Rather, the market is typically used by financial institutions, corporations, and municipalities to manage risk.¹¹⁴ These institutions “need to have the ability, particularly in the case of less liquid swaps, to restrict the dissemination of their trading interest, on a non-discriminatory basis, to specific recipients or categories of recipients.”¹¹⁵ If not, the ramifications could include skyrocketing prices based on the small number of trades and the ability

110. *Id.*

111. *Id.*

112. Letter from Edward J. Rosen, Partner, Cleary Gottlieb Steen & Hamilton LLP, to Elizabeth M. Murphy, Sec’y, Sec. & Exch. Comm’n, and David A. Stawick, Sec’y, Commodity Futures Trading Comm’n (Apr. 5, 2011) [hereinafter Rosen Letter].

113. See MARCO AVELLANEDA & RAMA CONT, INT’L SWAPS & DERIVATIVES ASS’N, TRANSPARENCY IN OVER-THE-COUNTER INTEREST RATE DERIVATIVES MARKETS 4 (Aug. 2010).

114. Gibson, *supra* note 12, at 382.

115. Rosen Letter, *supra* note 112, at 2.

of large block trades to quickly shift the market price of a particular swap upward¹¹⁶ and the threat of speculation—an issue in the credit default swaps market leading up to the financial crisis.¹¹⁷ Thus, as Mr. Rosen points out, these institutions tend to “opt for non-displayed execution methods for large size orders [and] orders for less liquid instruments . . . where confidentiality considerations,” (i.e., not moving the market), “outweigh the benefits associated with pre-trade transparency.”¹¹⁸ Accordingly, a securities-like exchange for swaps would threaten to make the buying and selling in swaps uneconomical based on the already illiquid market in which traders execute swap transactions.

Second, the pivotal role of dealers in the OTC derivatives market—matching counterparties and engineering the transaction to suit the needs of both parties¹¹⁹—counsels caution when implementing regulations that curtail their business. The *Financial Times* recently wrote that “[g]iven the indispensable role of dealers in the OTC derivatives market, it is clear that few structural changes can occur without dealer support.”¹²⁰ More bluntly, “nothing happens in OTC derivatives without major dealers blessing the moves.”¹²¹ Thus, recognizing the indispensable role dealers play in the market, instituting an exchange requirement could have serious consequences for the smooth functioning of the swaps market. If dealers’ roles are marginalized, the risk becomes that the market for matching up counterparties could dry up, resulting in institutions executing fewer transactions and a more illiquid market.

The effect swaps agreements had on the United States and world economies and the secrecy in which the market functions are certainly significant grounds for a greater role for federal agencies in regulating and overseeing the market. Nevertheless, the illiquid, and thus fragile, swaps market suggests caution when implementing new regulations that could have the effect of making swaps markets even more illiquid. Thus, the SEC should not require parties to execute swaps transactions

116. See, e.g., JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 80-82 (6th ed. 2009) (discussing the role of synthetic investments for professional traders as a means to avoid “moving the market” when large trades are made).

117. For an interesting book on the speculation in the credit default swaps market, see generally MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010).

118. Rosen Letter, *supra* note 112, at 5.

119. See MARSHALL & KAPNER, *supra* note 11 and accompanying text.

120. Michael Mackenzie & Gillian Tett, *Markets: Frozen in Time*, *FIN. TIMES* (June 15, 2010), <http://cache.ft.com/cms/s/0/bf3fd548-78b6-11df-a312-00144feabdc0.html#axzz1cgIdw7so> (quoting Paul Rowady, Senior Analyst, Tabb Group).

121. *Id.*

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on an exchange or an exchange-like execution facility. Rather, the SEC should allow the OTC derivatives market to continue to operate, but should adopt a regulatory, as opposed to a market, transparency approach.

III. THE SEC SHOULD ADOPT A REGULATORY, AS OPPOSED TO A
MARKET, TRANSPARENCY APPROACH

Proposed Regulation SB SEF, though it would likely increase the degree of transparency in the OTC derivatives market, is insufficient in that it does not adequately consider the significant differences between swaps and securities. As a result, it offers a proposed rule that works well for a liquid, securities-like market, but would introduce inefficiencies and disincentives into a much less liquid market such as swaps. On the other hand, situations such as that of AIG—who sold \$440 billion worth of credit default swaps that no federal regulator knew about—and the financial crisis generally warrant a greater role for federal regulators in the OTC derivatives market. This Part suggests a framework that will provide for that, but will still allow the OTC derivatives market to retain the flexibility that the dealer system fosters and the confidentiality against the market that helps institutions execute swap transactions.

There is a significant distinction between market and regulatory transparency. Market transparency refers to “the extent to which information on prices and quantities is disseminated among market participants.”¹²² For instance, this would mean that exchanges or swap execution facilities, at the most, would make pre-trade¹²³ and post-trade¹²⁴ numbers available to all participants in the market. In contrast, regulatory transparency is when regulators, and not market participants, are privy to timely trade information to effectively monitor the market.¹²⁵ The former could result in speculative activity and escalating prices for swaps that could destabilize the market and make the swaps market uneconomical.¹²⁶ The latter, by contrast, would serve two purposes central to preventing another financial crisis: requiring

122. AVELLANEDA & CONT, *supra* note 113, at 3.

123. “At its broadest level, pre-trade transparency consists of information accurately indicating the size and price of prospective trading interests, such as firm quotes in representative size both at the best firm bid and ask quotes and away from such quotes.” AVELLANEDA & CONT, *supra* note 2, at 5.

124. “Post-trade transparency refers to the dissemination of trade prices and volumes of completed transactions from all markets trading that security.” *Id.* at 6.

125. *See id.* at 20.

126. *See id.*

institutions to report their exposure in the swaps market and allowing regulators to monitor and regulate institutions' exposure and their interconnectedness.

Thus, this Article, above all else, argues for a regulatory transparency approach. In such a system, institutions engaged in swap transactions would report transaction and exposure data, but the government would keep that data strictly confidential.¹²⁷ As stated above, such data would allow regulators to monitor and respond to problems in the market, but would avoid the inefficiencies generated by an exchange or exchange-like execution facility—speculative activity and increased costs—and retain the role of dealers in the market to tailor transactions and match counterparties. Accordingly, the SEC should not mandate swaps to trade on an exchange or exchange-like execution facility, and should instead institute a regulatory transparency approach.

CONCLUSION

The financial crisis exposed the fragility of the financial system both in the United States and the much-larger world. It showed that our institutions are more interconnected, which resulted in a cascade effect: when one institution suffered, so did many others. The swaps market—most notably the credit default swaps market—was at the center of this morass. Consequently, Congress, having previously required minimal, if any, regulation of swaps, correctly enacted Dodd-Frank, which mandated that both the SEC and the CFTC regulate swap agreements in some form. The SEC's Regulation SB SEF, unfortunately, misses the mark. It emphasizes market transparency (threatening the swaps market with speculation and rising prices) and neglects regulatory transparency (providing regulators access to confidential transaction and exposure information). Regulatory transparency effectively splits the baby: allowing the fragile swaps market to continue to function, while instituting the regulatory oversight that the swaps market needs.

127. *See id.*