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Gambling on Our Financial Future: How the Federal Government Fiddles While State Common Law is a Safer Bet to Prevent Another Financial Collapse

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“When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done.”

I. INTRODUCTION

Warren Buffett once referred to derivatives as “financial weapons of mass destruction.” Academics, analysts, politicians and regulators have argued that one form of derivative contract was responsible, at least in significant part, for the mass destruction of the financial system in 2008: credit default swaps (“CDSs”).

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2. Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 15 (Feb. 21, 2003), http://www.berkshirehathaway.com/letters/2002pdf.pdf (“In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”).

3. See Zachary J. Gubler, The Financial Innovation Process: Theory and Application, 36 DEL. J. CORP. L. 55, 87–89 (2011); Janis Sarra, Financial Market Destabilization and the Role of Credit Default Swaps: An International Perspective on the SEC’s Role Going Forward, 78 U. CIN. L. REV. 629, 629 (2009); Lynn Stout, Derivatives and the Legal Origin of the 2008 Credit Crisis, 1 HARV. BUS. L. REV. 1, 27–29 (2011); Matthew Daneman, Morelle Helps Craft Model for Credit Default Swap Rules, DEMOCRAT & CHRON. (Rochester, N.Y.), Nov. 26, 2009, available at 2009 WLNR 24003345 (“Credit default swaps have been blamed for helping contribute to the near-collapse of insurance giant American International Group Inc., which was bailed out by taxpayers.”); Leela De Kretser, The Street, HERALD SUN (Melbourne), Oct. 21, 2008, available at 2008 WLNR 19938563 (“Ever since the US became aware of the role credit default swaps play in the financial crisis . . . .”); Eric Dinallo, We Modernised Ourselves into This Ice Age, FIN. TIMES, Mar. 31, 2009 (“Credit default swaps are the rocket fuel that turned the subprime mortgage fire into a conflagration.”); Gary Gensler, Chairman, Commodities Futures Trading Comm’n,
Eric Dinallo, the New York Superintendent of Insurance, compared the 2008 Financial Crisis to the 1907 Panic because in his opinion both were caused by unregulated betting on markets by people who did not own assets in those markets. He explained: “Many compare this financial crisis to the stock market crash of 1929, but it is closer to the credit freeze and bank panic of 1907 . . . . What has been forgotten is one major cause of the crisis—unregulated speculation on the prices of securities by people who did not own them. These betting parlours, or fake exchanges, were called bucket shops because the bets were literally placed in buckets.”

State law, judicial and statutory, formerly restrained betting on securities and financial assets by people who did not have any ownership interest in them. But by the turn of the third millennium federal law was used first to eviscerate all control by the states and then to eliminate all federal regulation of financial gambling. The result was a binge of financial wagering followed by a purge of a financial collapse. In the face of this collapse, some (including members of Congress) called for the total prohibitions of all credit default swaps. Others called for a prohibition on a portion of credit default swaps. This article will argue that these proposals have failed because they do not acknowledge that a credit default swap is a form capable of both good and bad uses and therefore requires a hermeneutic for distinguishing those CDS contracts which should be prohibited and those with legitimate uses. The

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4. Dinallo, supra note 3.
5. Id.
6. See infra Part III.
7. See Credit Default Swap Prohibition Act of 2009, H.R. 3145, 111th Cong. § 7(A) (2009) (“It shall be unlawful for any person to enter into a credit default swap agreement or contract.”); see also Shannon D. Harrington & John Glover, Credit-Default Swaps May Incite Regulators over Insider Trading, BLOOMBERG (Oct. 10, 2006), http://www.bloomberg.com/apps/news?pid=21070001&sid=aAMb0.6cgOLs.
federal preemption of state law regarding financial gambling cut off the law’s access to just such a hermeneutic.

I have argued elsewhere in favor of the superiority of making law through a dialectical process among general principles of natural law, developing customs as evaluated through common law judicial decisions, and precise targeted statutory enactments, rather than through comprehensive statutory regulation. The history of the regulation of derivatives presents a case study supporting the theoretical arguments I have advanced. This article will argue that comprehensive federal statutory preemption of developing state law in restraint of wagering failed both to preserve millennia-old philosophical and legal principles and to adapt those principles to the evolving practices of derivative trading. Hence, this article will conclude that regulation of derivatives should be returned to the prudent regulation of states, using a combination of common law principles and targeted statutes, rather than continuing with current federal omnibus preemption. To advance this argument, Part II will first explain the nature of credit default swaps and summarize their role in the financial collapse. Part III will describe (1) the historic philosophical and legal antipathy to gambling (including gambling in the form of financial speculation); (2) how those principles developed in the nineteenth and early twentieth centuries into nuanced legal rules restraining financial wagering, while still permitting useful contracts; and (3) the federal assassination of the developing application of these ancient principles to modern financial contracts by state courts and legislatures. Part IV will conclude by arguing for a repeal of all federal preemption and the continuation of the development of a nuanced state law that will permit economically useful and morally acceptable derivative contracts, while restraining destructive financial gambling with our economic future.

In 1999, Professor Lynn Stout observed that “[t]hroughout most of the nineteenth and twentieth centuries, American judges and legislators appear to have followed a policy of actively and deliberately discouraging speculative transactions. Recent years have seen a curious development, however. Lawmakers’ longstanding belief that speculation is harmful seems to be eroding.” It was during this time that Congress was preparing to put the final nail in the coffin of CDS regulation, thereby giving financial gamblers free reign to gamble on them and putting our entire financial system up as the ante. The resulting crisis fulfilled the earlier predictions of courts.

and commentators about the harms of financial wagering described in Part III. Only again allowing for the ongoing development of flexible and nuanced rules will we reestablish a legal regime that holds fast to core principles, while still allowing the flexibility to respond to changes in the financial markets.

II. CREDIT DEFAULT SWAPS

This part will examine the nature of the contracts known as credit default swaps. First, Section A will define a credit default swap and examine its potential uses. Section B will survey some of the available data on the size, scope and nature of the CDS market and review the evidence that the massive CDS market contributed significantly to the systemic collapse of the financial system.

A. What are Credit Default Swaps?

Credit default swaps are derivative transactions. "The term 'derivatives' references 'a vast array of privately negotiated over-the-counter . . . and exchange traded transactions,' including interest-rate swaps, currency swaps, commodity price swaps and credit derivatives—which include credit default swaps."\(^1\) These transactions are described as derivatives "because each type of derivative agreement derives its value from an asset referenced in the contract."\(^2\) The Ninth Circuit defined a swap as "[(1)] a contract between two parties . . . [(2)] to exchange . . . cash flows at specified intervals, [(3)] calculated by reference to an index."\(^3\) Applying this definition to a credit default swap we see it is a financial (1) contract where one party (the "Protection Seller") agrees (2) to make payments to its counterparty (the "Protection Buyer"), contingent on the occurrence of specified events ("Credit Events"),\(^4\) (3) with respect to a defined reference obligation (the

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14. Such events may include things like the bankruptcy or restructuring of, or the acceleration or default under a particular obligation of, a particular entity. See INT'L SWAPS & DERIVATIVES ASS'N, INC., 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 30, 33 (2003), available at
"Reference Obligation") of a specified person (the "Reference Entity") in exchange for the payment of a fee. A credit default swap is a derivative because the contract derives its value from the value of the Reference Obligation. The Reference Obligation may range from individual "debt obligations such as a specific debt security (a 'single name product'), a group or index of debt securities (a 'basket product'), or collateralized loan agreements, collateralized debt obligations, or related indexes." The Credit Event must have occurred in between the effective date of the transaction and the agreed termination date. The contingent payments are generally calculated by finding the difference between a specified notional amount of the Reference Obligation and the market value of the obligation near the time of settlement. The transaction is typically documented by use of forms promulgated by the International Swaps and Derivatives Association ("ISDA"). The parties enter into a Master Agreement, which governs all of their swap and derivative transactions and incorporates special definitions applicable to credit derivative transactions. The terms of individual transactions are documented in confirmations. Typically, the Protection Buyer agrees to transfer a specific security or monetary obligation constituting the Reference Obligation to the Protection Seller for the face amount of such Reference Obligation. In this form, a credit default swap is...


15. See Eternity Global, 375 F.3d at 172 (citing Joyce A. Frost, Credit Risk Management from a Corporate Perspective, in HANDBOOK OF CREDIT DERIVATIVES 89–96 (Jack Clark Francis et al. eds., 1999)); see also Ari J. Brandes, A Better Way to Understand the Speculative Use of Credit Default Swaps, 14 STAN. J.L. BUS. & FIN. 263, 268 (2009) (summarizing the nature of a CDS transaction and suggesting the terms "writer" and "holder" are more appropriate than "Seller" and "Buyer").


17. See INT’L SWAPS & DERIVATIVES ASS’N, supra note 14, at 2 (defining “Notice Delivery Period”). However, if the Credit Event involved a failure to pay the Reference Obligation, such failure may occur after the Termination Date if an act constituting a “Potential Failure to Pay” has occurred prior to the agreed termination date.


20. See AON Fin. Prods., 476 F.3d at 93 n.4. See generally INT’L SWAPS & DERIVATIVES ASS’N, supra note 14 (providing the definitions of words used in credit derivative transactions).


much like a put option on a security. If the market value of the Reference Obligation has declined since the contract was formed, the Protection Buyer profits to the extent of the difference between the face amount of the Reference Obligation and its market value at the time of settlement. Yet, credit default swaps do not have to operate like a put option. The parties may agree to settle the transaction either for a single cash payment ("Cash Settlement") or by delivering obligations or securities in exchange for a cash payment ("Physical Settlement"). If a Cash Settlement is utilized, the seller pays the buyer either the amount specified in the applicable confirmation or the amount equal to the difference between the face amount of the Reference Obligation and its then market value as determined in accordance with the applicable valuation methodology. Even if Physical Settlement is chosen, the buyer need not deliver the Reference Obligation with respect to which the transaction was made, but can deliver a different obligation instead. Although the Protection Buyer may own the Reference Obligation, ownership is not necessary at the time of contracting or settlement of the credit default swap following the Credit Event.

Notwithstanding Professor Ramirez's blanket categorization of all derivatives as "wagering contracts," CDS contracts are hard to classify due to the high flexibility of the documentation, in particular the possibility of Cash or Physical Settlement (including with different obligations than the Reference Obligation). "Credit default swap" is an amorphous term. It references a set of highly flexible documentation which can be utilized for a wide variety of economic transacting. Yet, two general uses of credit default swaps can be distinguished: risk shifting or hedging, and pure financial speculation. Although CDS contracts were initially used, and can still be employed, to insure against or hedge the risk of default on debt obligations

23. Id.
24. See INT'L SWAPS & DERIVATIVES ASS'N, supra note 14, at 37 (defining "Settlement Method" as either Cash Settlement or Physical Settlement, as selected in the applicable Confirmation).
25. See id. at 38 (defining "Cash Settlement Amount" and related definitions).
26. See Eternity Global, 375 F.3d at 173; INT'L SWAPS & DERIVATIVES ASS'N, supra note 14, at 11 (defining "Deliverable Obligation" to include "any obligation of a Reference Entity").
27. See Eternity Global, 375 F.3d at 173, 182 ("The CDS contracts did not require or contemplate that the credit protection buyer (here, Eternity) would hold the reference bonds."); see also Stout, supra note 3, at 6.
held on the Protection Buyer’s balance sheet, the market evolved into offering credit default swaps to Protection Buyers who did not have an economic interest in the Reference Obligation. Thus, although a credit default swap might have a similar economic effect to insurance in a particular context where the Protection Buyer owns the Reference Obligation, neither is the Protection Buyer contractually obligated to demonstrate an insurable risk nor is the Protection Buyer required to demonstrate any actual loss in order to receive a payment following a Credit Event. The absence of these two elements from CDS contracts transforms them from insurance (or other risk-shifting) contracts into a vehicle for betting on the financial health of debt-issuing institutions. This innovative use of credit default swaps is referred to as “uncovered” or “naked” credit default swaps. Credit default swaps have thus been recognized as a transaction form that can be adapted to risk management purposes in a manner similar to buying insurance or for speculative purposes, in an attempt to generate income separately from insuring against or transferring risk so as to increase overall rates of return on other investments. Critics have described the latter use as gambling.

CDS contracts can also serve a hybrid purpose between these two poles of insurance and speculation. For example, in the Eternity Global case, Eternity

30. See Brandes, supra note 15, at 271 (citing TAX SECTION, supra note 29).
32. A Second Circuit case was decided in part on the recognition that credit default swaps need not match risk exposure and protection. In AON Financial Products, Inc. v. Societe Generale, AON sold a credit default swap to Bear Stems that defined the Reference Obligation as a certain surety bond issued by the Reference Entity defined as the Government Service Insurance System (“GSIS”), an agency of the Philippine Government. 476 F.3d 90, 92 (2d Cir 2007). AON later bought a credit default swap from Societe Generale in which the Reference Entity was the government of the Philippines and the Reference Obligation was a certain treasury bond issued by it. Id. at 94. The Second Circuit held that non-payment by GSIS of the surety bond, although constituting a Credit Event under the AON Bear Stems credit default swap, did not constitute Credit Event under the AON Societe Generale transaction since the two transactions used different Reference Entities and Reference Obligations, notwithstanding the fact that AON considered the two transactions to be related. Id. at 99–102.
33. See Johnson, supra note 12, at 131–32; Stout, supra note 10, at 705 (observing that “while derivatives are often described as instruments for hedging against business risks, they are also frequently used as vehicles for speculating on everything from fuel oil prices to home mortgage rates”).
34. Johnson, supra note 12, at 197.
36. See id.
held positions in the Argentine corporate bond market. It purchased credit default swaps which used Argentine sovereign debt instruments as the Reference Obligations. Argentinean governmental obligations bear some relationship to the risk element contained in corporate debt originating from that country, but the two are not identical. In an insurance context, this would be analogous to buying an insurance policy on a neighbor’s house instead of your own house on the theory that a natural disaster that destroys your house (such as a flood or tornado) will likely affect your neighbor’s house as well.

The line between these two uses of credit default swaps is difficult to distinguish in many cases. The purchase of credit default swaps can be used for speculative profiting and can lead to perverse conflicts of interest even when the Buyer holds an economic interest in the underlying obligation. In the so called Magnetar Trade, the originator of a securitization pool appeared to retain an interest in the strip of risk profiles contained in the structure; but in reality, the originator only retained an economic interest in a small portion of the bottom equity piece by using credit default swaps to eliminate any exposure to the senior securities. The originator of the structure, who appeared to have a financial interest aligned with the investors to whom securities were sold, was in fact in a position to profit from the default of those securities by virtue of the credit default swaps it held. Thus, although they held an interest in the Reference Obligations, the credit default swaps were being used to generate a profit on the overall transaction if the transaction they structured defaulted.

A more recent example of the use of CDS to gamble has been compared to the practices of gangsters. Blackstone Group L.P. acquired bonds of Codere S.A., a public Spanish company and CDS-linked to those bonds. A division of Blackstone then acquired a credit facility of Codere. Blackstone negotiated an extension of repayment of this facility and an increase in borrowings, conditional on Codere missing its next interest payment on its bonds, resulting in a payment to Protection Buyers of the related CDSs.

38. Eternity Global, 375 F.3d at 171.
39. Id. at 174.
40. RAMIREZ, supra note 8, at 206.
41. Id.
44. Id.
45. See Primack, supra note 42; Ruhle et al., supra note 43.
Blackstone is reported to have made a profit of between $15.6 million and $18.7 million on the CDSs as a result of the late bond payment. Peter Rose of Blackstone, although attempting to justify Blackstone’s actions by arguing it had invested in Codere and helped Codere avoid a bankruptcy, openly admitted that CDSs were used to gamble on Codere bonds. He explained the Protection Sellers “through their use of credit default swaps, were betting on when the Company would default. They were like gamblers betting on the over/under spread, but having no interest in the outcome of the game.”

Almost prophetically, approximately three years before the Codere incident, one commentator speculated about the consequences of an investor in a company’s bonds holding a larger position in related CDS: “Will he not have interests directly at odds with those of other creditors, since he will do better if the company ends up with less to pay its creditors? Might that creditor seek to, and perhaps be able to, sabotage the company’s best hopes for revival?”

As these two examples illustrate, CDSs can be used to place wagers on the performance of companies’ securities. Such financial gambling can also create conflicts of interests and perverse incentives (such as contractually requiring a company to default in payment so as to trigger a CDS payment). Such a move in the case of Codere has been equated to a mobster purchasing insurance on a restaurant he is about to set afire.

B. The CDS Market and the Financial Collapse

1. The Historic Size and Scope of the Market

The entire market for derivatives is estimated to reach approximately one quadrillion—even after the 2008 collapse. The proportion of this market involving credit default swaps has exploded since the turn of the millennium. The ISDA began surveying the credit default swap markets in mid-year 2001, when the total notional amount outstanding was only $631.497 billion. The size of the CDS market steadily increased until it hit its peak at year-end 2007

46. Ruhle, supra note 43.
47. See Primack, supra note 42.
48. Id.
49. Norris, supra note 8.
50. Primack, supra note 40.
51. See id.
52. RAMIREZ, supra note 28, at 83.
(during the commencement of the financial crisis), with $62.2 trillion total notional amount outstanding. The market then experienced consistent declines until mid-year 2010, when the notional amount outstanding was $26.3 trillion. Since 2010, the CDS market has remained relatively stable. The most recent survey indicates that the total notional amount outstanding was $26.9 trillion as of mid-year 2012. To put these numbers in perspective, at certain times the CDS market was larger than the equities, treasuries and mortgages markets combined.

The liquidity of the CDS market is enhanced by the presence of indices in North America (Dow Jones CDX) and Europe (iTraxx). These indices track the credit default spreads (bid spreads and ask spreads) for the top 125 investment-grade companies on each continent. The overwhelming majority of CDS market participants, 88% of Protection Buyers and 86% of Protection Sellers, are banks, securities firms, and insurance companies. Virtually 100% of market participants are institutional investors.

Professor Lynn Stout’s comment about the nature of the entire derivative market at its inception in the 1990s is equally applicable to credit default swaps: “some end users employ derivatives to hedge against business risks from fluctuating interest rates and commodity prices, while others are driven by speculative passions.” At least prior to the financial crisis, most CDS contracts are estimated to have been purchased for pure speculative purposes. This conclusion can be deduced from the fact that the notional

54. Id.
55. Id.
57. Id.
60. Id.
61. Id. at 182 (citing David Z. Nirenberg & Richard J. Hoffman, Are Credit Default Swaps Insurance?, 3 DERIVATIVES REP. 7 (2001)).
62. Id.
63. See Stout, supra note 10, at 766.
amount of CDS contracts written exceeded the outstanding principle amount of the Reference Obligations. By way of example, Lynn Stout explains:

In 2008, for example, the $67 trillion CDS market was made up almost entirely of CDS written on certain mortgage backed bonds and the corporate bonds of a limited number of favored issuers, such as GE. Meanwhile, the total value of all asset-backed and corporate bonds outstanding in the U.S. that year was only $15 trillion.

Hedge funds, which specialize in speculative investment, appear to account for approximately a third of the CDS market. According to the New York Insurance Department, in 2009, approximately only 20% of credit default swaps had been purchased by someone that owns the underlying Reference Obligation. The other 80%—often called naked swaps—are not necessarily completely unrelated to offsetting or hedging risk. They may be used to hedge against a risk other than the risk of default on the Reference Obligation. For example, they could be used to hedge against default risk on receivables of the Reference Entity. Yet, many analysts agree that at least some of the 80% have purchased CDS contracts "solely to make a directional bet against a firm or structured finance product" to which they have no other exposure.

65. Michael S. Gibson, Credit Derivatives and Risk Management 18 (Fin. & Econ. Discussion Series, Fed. Reserve Bd., Working Paper No. 2007-47, 2007), available at http://www.federalreserve.gov/pubs/feds/2007/200747/200747pap.pdf ("[I]t is now common for the notional amount of CDS outstanding referencing a particular issuer to be larger than the face value of the issuer's bonds outstanding."); see Regulatory Reform and the Derivatives Market: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry, 111th Cong. 134 (2009) (statement of Lynn Stout, Paul Hastings Professor of Corporate and Securities Law, University of California, Los Angeles School of Law) ("When the notional value of a derivatives market is more than four times larger than the size of the market for the underlying, it is a mathematical certainty that most derivatives trading is speculation, not hedging.").

66. Stout, supra note 3, at 25.

67. The Great Untangling, ECONOMIST, Nov. 6, 2008, at fig.2 (illustrating that hedge funds wrote 32% of CDS in 2007).

68. Andrew Ackerman, Securities Administrators Urge Regulation of Derivatives, Hedge Funds, BOND BUYER, Jan. 2009, at 5, 30.

69. Id.

70. Id.

71. Id.

72. Id.
2. CDS and the Financial Market Collapse

The forced sale of Bear Stearns, the bankruptcy of Lehman Brothers, and the failure of American International Group ("AIG") may be attributed at least in significant part to their use of CDS contracts. The financial ailments of these entities were compounded by leveraging their CDS investments. The explosive growth of CDS over a relatively brief timeframe, from 2000 to 2008, also contributed to the enormity of these entities' problems. In analyzing the market conditions leading to the failure of these institutions, difficulty arises in attributing liability specifically to CDS as opposed to other investment tools. The faltering of these institutions is largely considered a result of exemption from regulation, lack of proper disclosure requirements, insufficient loan loss reserves, and failure to anticipate a complete collapse in the mortgage market. These causes were not only present in CDS, but also in asset-backed securities and other investment tools. Still, the sheer size of the CDS market is evidence that CDS liability contributed heavily to institutional failure—more heavily than the $2.5 trillion asset-backed securities market in 2008. Finally, CDS liability contributing to the failure of these entities may be partially measured in relation to the extent these CDS were tied to "junk" or "high-yield" bonds that defaulted due to the general market failure.

Some of the underlying purposes behind CDSs are to enhance liquidity, increase efficiency, and apportion risk; however, when CDS are sold as insurance for precarious assets to those not having exposure to those assets, systemic risk such as that seen in the financial crisis, is actually enhanced. AIG errantly did exactly that by selling $80 billion worth of subprime-related CDS from 1998 until 2005. Many swaps were offered by AIG on
collateralized debt obligations ("CDOs"), which were backed by mortgage bonds, auto loans, or credit-card receivables. These CDOs were extremely complex, which made valuation increasingly difficult. Also, providing this "insurance" had the effect of reducing the incentive for diligent underwriting. By early 2006, AIG decided to back out of this market as it was exposing itself to excessive liability through these multi-sector CDO swaps. But significant damage had already been done. In the fall of 2008, AIG was liable on over $400 billion in CDSs and had posted $50 billion worth of collateral to its trading partners, mostly in response to the plummeting value of securities referenced by CDSs sold by AIG.

A simplified example can demonstrate how the writing of CDS contracts multiplies the effects of issuer default and increases systemic risk. Assume XYZ Company sells $100 million of subordinated debentures ("Notes") to ABC investor. If XYZ defaults in payment on these notes, the maximum direct lost investment will be $100 million on the part of ABC investor. If ABC investor shifts this risk by buying a $100 million notional amount CDSs with a Credit Event of an actual XYZ Note payment default, then the risk is merely transferred to its Protection Seller—but not increased. If additional Protection Buyers purchase CDS contracts using the XYZ Note default as a Credit Event in notional amounts totaling $500 million, then a default by XYZ on the Note would result a loss by Protection Sellers of up to $500 million in Credit Event payments—an additional $500 million loss beyond the original $100 million direct loss due to default by XYZ on the Note. Thus, an additional $500 million loss overhang is created in the financial system by the sale of $500 million notional amount of CDSs referencing the XYZ Note. In reality, the situation is worse because Credit Events can include potential failures to pay (events that might precede an actual failure to pay). In this case, a $500 million loss would be suffered by the Protection Sellers even if XYZ never actually defaults on the Note. This would be equivalent to an insurance policy paying upon a potential event of destruction such as a

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83. Id.
85. See Mollenkamp, et al., supra note 82.
86. Id.
87. See id. at 1.
88. See Stout, supra note 3, at 23 (using a similar example).
tornado touching down ten miles near the insured’s home. As a result of a potential destruction of his home, the homeowner could recover a payment equal to the value of his undamaged home from his insurer. Unlike insurance contracts which require an insurable interest, Protection Buyers do not have to own any XYZ Notes to buy credit protection. This is equivalent to a person buying fire insurance on his neighbor’s house. Repeated instances of such a transaction, related not to home destruction but a variety of financial instruments, is what created the systemic risk that exploded in the crisis.

After 2003, the CDS market grew exponentially, reaching $45.5 trillion by 2007, while the market for mortgage-backed securities gradually rose to only $7.1 trillion. This disparity indicates to what extent CDS transactions multiplied systemic risk rather than shifting the risk of mortgage default between participants. The numbers for the entire OTC derivatives market are even more astounding. The estimated size of the entire OTC derivatives market had swelled to $670 trillion, which translates into in excess of $100,000 of notional derivative loss exposure for every living human being alive, which is approximately four times the total per capita wealth of the population of the planet. Thus, CDS contracts have the ability to accelerate, create, increase and disperse losses resulting from credit failures or even potential credit failures throughout the financial system. When failures in the mortgage sector began to emerge, CDSs served as the conduit to multiply and spread these failures throughout the financial system.

Although the causes of the financial crisis—and the collapse or near collapse of major institutions previously believed to epitomize stability—is myriad, it is clear that CDSs and other credit derivatives played a major role in the financial crisis and the demise of massive institutions. Lehman Brothers was one of the largest market makers in municipal credit-default

89. See infra Part III.
91. See Stout, supra note 3, at 23.
93. See Gretchen Morgenson, Behind Biggest Insurer’s Crisis, a Blind Eye to a Web of Risk, N.Y. TIMES, Sept. 28, 2008, available at http://www.nytimes.com/2008/09/28/business/28melt.html?pagewanted=all (“Although America’s housing collapse is often cited as having caused the crisis, the system was vulnerable because of intricate financial contracts known as credit derivatives, which insure debt holders against default.”)).
swaps, along with Citigroup, Goldman Sachs and Merrill Lynch. CDS also played a key role in the demise of Bear Stearns where confidence in the company diminished due to counterparty risks posed by CDSs sold by Bear Stearns. A report in October of 2007 discussed the large number of CDSs sold by Bear Stearns, with many of these CDSs relating to bonds backed by subprime mortgages. In selling these CDSs, Bear Stearns mistakenly bet that the housing market would recover, or at least stop deteriorating. As the housing market collapsed and issuers of securities faced possible payment defaults, Protection Sellers started to see the multiplication of losses inherent in the CDS market begin to materialize. The rest, as they say, is history.

III. THE HISTORIC MORAL AND LEGAL CASE AGAINST ECONOMIC GAMBLING AND ITS FEDERAL ASSASSINATION THROUGH PREEMPTION

George Santayana once observed that "[t]hose who cannot remember the past are condemned to repeat it." Although the financial collapse may have come as a surprise to some people, it would not have been unexpected to generations of our predecessors steeped in a philosophical and legal antipathy to wagering. This Part summarizes that history for those who cannot remember it after decades of federal law have attempted to erase it from memory. Section A summarizes the long history of the moral case against profiting from betting on prices. Section B examines how this general moral principle imprinted itself in state law by surveying the legal treatment of commodity futures contracts and speculation on stock market prices. Section C relates how federal law suppressed both the underlying philosophical aversion to speculative wagers and the state law (judicial and statutory) built around this opposition.

95. Morgenson, supra note 58.
97. See id.
98. 1 GEORGE SANTAYANA, THE LIFE OF REASON; OR THE PHASES OF HUMAN PROGRESS 284 (Dover 1980) (1905).
A. Anti-Wagering Philosophy from the Ancient World to Modern Times

The law’s hostility to gambling has developed in light of centuries-old “philosophical, theological, social, and economic” beliefs. Skepticism about a particular type of gambling—speculation on prices—has a long history dating back at least as far as the Greek philosopher Aristotle. In his discussion of the proper political order, Aristotle distinguishes between two types of merchants. He argues that a merchant who regulates his profits in order to meet his needs was involved in natural and legitimate acquisition, but that business engaged in simply to amass wealth and not just to satisfy needs was unnatural because it had no limits and constituted an infinite appetite for riches. Since a desire for riches has no limit, restraint must be imposed from human reason. For centuries after Aristotle, skepticism about trade and commerce persisted. Although some writers simply dismissed all commerce as evil, others attempted a more refined evaluation based on the Aristotelian distinction between commerce limited by human need and an unregulated drive to amass wealth that was disconnected from satisfying human need. St. Thomas reiterates the Aristotelian distinction between valuable commerce and infinite wealth acquisition:

100. See Aristotle, Politics, in THE BASIC WORKS OF ARISTOTLE I at 1256a & b (R. McKeon ed., 1941).
101. See id.
102. See id. at 1256a–1256b.
103. See id. at 1257a & b; see also ST. THOMAS AQUINAS, SUMMA THEOLOGICA, pt. I-II, q. 1, art. 2, Reply to Obj. 3 (Fathers of the English Dominican Province trans., rev. ed. 1920) (c. 1274), available at http://www.newadvent.org/summa/2001.htm#article2 (explaining how natural appetites must be subject to reason); id. at pt. I-II, q. 77, art. 4, available at http://www.newadvent.org/summa/3077.htm#article1 (explaining how the root of sin is theordinate desire for something).
104. See, e.g., ST. AMBROSE OF MILAN, ON THE DUTIES OF THE CLERGY, bk. III. ch. 6, p.150–151 (Philip Schaff ed., 2006), available at http://www.documentacatholicamnia.eu/03d/0339-0397_Ambrosius_De_Officiis_Ministorum_Libri_Tres_%5BSchafl%5D_EN.pdf (“The holy man says that he has never been engaged in business. For to get an increase in price is a sign not of simplicity but of cunning... Why dost thou use the industry of nature and make a cheat of it?... Then thou collectest wealth from the misery of all, and callest this industry and diligence, when it is but cunning shrewdness and an adroit trick of the trade. Thou callest it a remedy, when it is but a wicked contrivance. Shall I call this robbery or only gain? These opportunities are seized as though seasons for plunder, wherein, like some cruel waylayer, thou mayest fall upon the stomachs of men... Thy gain is the public loss.”); DIANA WOOD, MEDIEVAL ECONOMIC THOUGHT 112 (Cambridge Univ. Press 2002).
A tradesman is one whose business consists in the exchange of things. According to the Philosopher (Polit. i, 3), exchange of things is twofold; one, natural as it were, and necessary, whereby one commodity is exchanged for another, or money taken in exchange for a commodity, in order to satisfy the needs of life. Such like trading, properly speaking, does not belong to tradesmen, but rather to housekeepers or civil servants who have to provide the household or the state with the necessaries of life. The other kind of exchange is either that of money for money, or of any commodity for money, not on account of the necessities of life, but for profit, and this kind of exchange, properly speaking, regards tradesmen, according to the Philosopher (Polit.i, 3). The former kind of exchange is commendable because it supplies a natural need: but the latter is justly deserving of blame, because, considered in itself, it satisfies the greed for gain, which knows no limit and tends to infinity. Hence trading, considered in itself, has a certain debasement attaching thereto, in so far as, by its very nature, it does not imply a virtuous or necessary end. Nevertheless gain which is the end of trading, though not implying, by its nature, anything virtuous or necessary, does not, in itself, connote anything sinful or contrary to virtue: wherefore nothing prevents gain from being directed to some necessary or even virtuous end, and thus trading becomes lawful. Thus, for instance, a man may intend the moderate gain which he seeks to acquire by trading for the upkeep of his household, or for the assistance of the needy: or again, a man may take to trade for some public advantage, for instance, lest his country lack the necessaries of life, and seek gain, not as an end, but as payment for his labor.106

Thus, the act of being in the business of trading for profit must be evaluated in light of the reason for trading and the circumstances surrounding the activity. If undertaken to satisfy a need, it is legitimate. But if trading is undertaken merely to amass wealth and is detached from satisfying needs, it is unnatural and immoral. As the twelfth century jurist, Gratian, explains, seeking profit merely for its own sake is disgraceful:

Everyone who in the time of harvest or grape gathering, not out of necessity but on account of greed, gathers together the year’s food harvest or wine, by a proverb of credit, he gathers together one peck for two denari (silver coins), and he continuously stores it up until

106. Id.
it may be sold for four denari or six, or more, we call this disgraceful profit. 107

This disgraceful profit is gained by mere price speculation or wagering on movements of prices in contrast to just compensation for contributing something to the production or distribution of goods satisfying human need. According to St. Thomas, to be licit, the intention of profiting from trade must be limited in two ways. First, the trade must be oriented towards a proper good such as the support of one’s family or the poor or for the common good of the community. Second, the amount of profit sought must be moderated (subjected to a limit). The profit must be proportional to the value added by the tradesman to the goods involved. 108 Thus, a categorical judgment cannot be made with respect to those who buy at one price and sell at another. A more detailed examination of the circumstances is necessary. John W. Baldwin summarizes a three-fold distinction among those who profit from buying cheaply and selling dearly and the conclusions that flow from such distinctions, developed by the twelfth century canonist Rufinus thus:

First of all, there is the case of one who buys goods for his own or household use with no intention of reselling these goods at a profit. At a later date, he discovers that he is forced through circumstances of necessity (necessitas) or expediency (utilitas) to sell these goods. . . . This category of buying cheap and selling dear because of necessity Rufinus permitted to both laity and clergy. The second category deals with the artisans and craftsmen and occurs when one buys goods cheap and then by changing or improving them, he is able to sell them at a higher price. The higher price for which he sells the goods is justified by both the expenses (impendium) and the labor (labor) he as an artisan has expended upon the goods in order to improve them. This type of business (negotiatio) is essentially honorable (honestus) and permitted always to the laity and only occasionally to the clergy. . . .

The final category of buying cheap to sell dear is exclusive of the first two. If one buys goods cheap with the sole motive of selling them later at a higher price for profit without having changed the form of the goods through added expenses or labor and without

108. AQUINAS, supra note 105.
being compelled to do so by necessity or expediency, then that one is conducting a commercial enterprise (negotiatio) in the truest sense of the word. This pure merchandising, although permitted (licitus) to the laity, was unconditionally forbidden to the clergy. To the laity it could be an honorable (honestus) or a shameful (turpis) affair. If no labor or expense were involved, for example, if one made profits by observing the market and buying in times of plenty and selling in times of famine, the enterprise was immoral. . . If, however, heavy expenditures had been made or if the merchant was fatigued by hard labor, then the enterprise was assessed as honorable, unless some other unworthy means intervened.109

Thus, although trading in goods and services is certainly a valuable contribution to the common good of society, merely wagering on changing prices serves no human need and is not constrained by any natural limit. According to many philosophers and jurists a trader is justly entitled to a profit proportionate to any value he added to the goods by: improving them, storing them, certifying their value, or transporting them.110 Yet, traders who “merely operate to increase prices and make a profit” (i.e., wager on price movements) without contributing anything of value to the goods exact an unjust profit and “should be banished.”111 Rufinus’s definition of the third category of trading constituting unjust price speculation is echoed in modern definitions of financial speculation. Lynn Stout summarizes contemporary definitions of speculation thus:

Theorists generally use the word “speculator” to refer to someone who purchases an asset with the intent of quickly reselling it, or sells an asset with the intent of quickly repurchasing it. This approach distinguishes speculators from those who trade in goods and services because they produce or consume them, and also may offer a rough means of differentiating short term “speculation” from long term “investment.”112

In other words, speculators take bets on the movement of prices and attempt to profit by such bets without contributing any value to the underlying asset or the economy, such gambling resulting in pure wealth transfers. Heinrich Pesch, S.J. summarized the distinction between legitimate profit, even fortuitously gained, and harmful financial gambling which for centuries the

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111. Id. at 451.

Christian philosophical tradition, rooted in Aristotelian philosophy, condemned thus:

Ethics does not rule out every kind of unearned profit. There are, for example, gifts, inheritance, increases in value due to natural and social causes. Differences in the economic quality of the soil, which makes possible production that is more abundant and of better quality, give rise to differential economic rents. Similar profits result in other areas from conditions of production which are relatively speaking more favorable, just as there are windfall profits coming from objectively legitimate developments in the price structure. But it is something else to strive for profits at the expense of one’s fellow man. Great gambling windfalls and changing market values on the exchanges, etc., do not descend from the heavens. Such money is taken from somewhere else without any service of equivalent value having been rendered. Christian ethics stands opposed to such and similar kinds of unjust profits, even if it is not possible to determine precisely who, in particular, was harmed by such transactions and to what degree. The economy is not a field waiting to be plundered.\textsuperscript{113}

Profits from pure speculation are not wealth producing; they add no value to the overall economy. Financial gambling is a destructive force in the economy, draining investment away from productive activities since “[t]he seductiveness of speculative gain gradually encroaches and displaces honorable, honest, and persistent work.”\textsuperscript{114} Rather than contributing to the growth of the economy, financial wagers result merely in wealth redistribution.\textsuperscript{115} As Father Pesch notes in commenting about a historical economic crisis produced by excessive speculation: “The money which people lost in that calamity did not however, ascend to heaven; it disappeared instead in certain pockets . . .”\textsuperscript{116}

In parallel to the Western opposition to speculative wagering, Islamic law (Shari’\textsuperscript{a}) has also opposed speculation (ghara).\textsuperscript{117} Transactions involving an unacceptable level of risk or uncertainty are unenforceable under Islamic

\textsuperscript{113} HEINRICH PESCH, ETHICS AND THE NATIONAL ECONOMY 98–99 (Rupert Ederer trans., IHS Press 2004).
\textsuperscript{114} Id. at 161.
\textsuperscript{115} See id.
\textsuperscript{116} Id.
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118. See Sabahi, supra note 117, at 491–92.
119. See Geissst, supra note 17, at 278.
120. Sabahi, supra note 117, at 491.
121. See Stout, supra note 3, at 9; Stout, supra note 10, at 745–46.
122. See Stout, supra note 10, at 745–46.
123. See id. at 763.
or a country while handing them a license to kill.”125 Professor Stout’s evaluation of speculation “suggests that common sense and the common law may be far more solidly grounded in the economic realities of the market” than the economic theory of the decades preceding the deregulation of speculative derivatives.126

Thus, there is a long philosophical and legal hostility in the Western tradition against mere gambling on prices. Lynn Stout has noted the stark difference between modern policy makers’ attitudes towards the emergence of the massive OTC derivatives market dominated by price speculators and virtually all of recorded history in the West. “In an earlier era, lawmakers would have viewed the sudden appearance of an enormous speculative market as a menace to the public welfare.”127 Historically, this hostility was translated into legal policies against wagering of all forms, including price speculation. Yet, in more recent times, hostility toward speculation (at least in the financial markets) gave way to optimism about the economic efficiency of speculation.128 The remainder of this part will examine the history of anti-wagering and anti-speculation law, culminating in its repeal with respect to credit default swaps prior to the crisis.

B. The Legal Case Against Financial Wagering

1. Legal Hostility to Gambling in General

Consistent with ancient and medieval philosophical opposition to speculation, state contract law has held gambling or wagering contracts to be unenforceable as against public policy unless specifically authorized by legislation.129 Although some states have enacted particular exceptions to permit regulated gambling, courts still consider gambling as against public

125. George Soros, IIF Spring Membership Meeting Address, GEORGESOROS.COM (June 10, 2010), http://www.georgesoros.com/interviews-speeches/entry/iif_spring_membership_meeting_address_june_10_20101/.
126. See Stout, supra note 10, at 764.
127. Id. at 706.
128. Id. at 707.
policy strictly construing such statutes. Much of the difficulty in applying this prohibition involves distinguishing wagering or gambling from legitimate contracts, which is the same distinction that runs all the way back to Aristotle. In distinguishing gambling from other activities, either at common law or for purposes of interpreting the terms gambling or betting in a statute, courts have generally looked for the combination of three elements: (1) payment of price (2) for an opportunity to receive a prize or other value (3) determined by chance or fortune. Williston focused on this essential element to detect wagering contracts: “if . . . [the contract] were enforced, the consideration received would not be commensurate with the detriment imposed on one side.” Another way of expressing this characteristic is that one party will gain value and the other will lose upon the happening of the specified contingency.

Once contracts are identified as constituting a wager or gambling contract, they are deemed to be “illegal” and consequently unenforceable, “except where expressly authorized by statute.” The illegality of betting is often established by specific statutes and often subject to specified exceptions. But even in jurisdictions that lack specific legislation, the common law refusal to enforce contracts contrary to public policy “is broad enough to proscribe bargains in which only one side faces any risk.”

Absent a criminal statute, the early common law determination that betting was against public policy did not render the contract subject to criminal sanctions, but rather simply unenforceable.

An early English statute, The Statute of Anne, enacted in 1710, not only prohibited the enforcement of gambling liabilities, but further provided the losing party in the wager an action to recover gambling debts previously

132. LORD, supra note 129.
134. LORD, supra note 129.
135. Id.
136. Id. (citing RESTATEMENT (FIRST) OF CONTRACTS § 520 cmt. a, illus. 11 (1973)).
137. LORD, supra note 129.
138. An Act for the Better Preventing of Excessive and Deceitful Gaming, 9 Ann., c. 14, §§ 1–2, sch. 4 (1711) (Eng.).
settled. The English courts supplemented the statute by prohibiting an action by a gambling winner to enforce a gaming debt. American legislatures and courts continued this English tradition of enhancing and expanding the consequences of engaging in gambling contracts that contravene public policy. Following the American Revolution, the Statute of Anne ceased to be controlling law but it became "part of the law in a number of the states via case law or statute." Additionally courts have often declared the enforcement of wagering contracts a waste of judicial resources.

As noted in Part I, when the panic of 1907 was considered to have been caused in large part by wagers placed on the stock market in so called bucket shops, states—including the financial capital of New York—enacted specific statutes prohibiting financial wagers on the stock market. The original version of the Commodity Exchange Act of 1936, the amendment of which would eventually eliminate all regulation of financial gambling, acknowledged the deleterious effects of wagering in the form of speculation on prices: "Excessive speculation in any commodity under contracts of sale . . . for future delivery . . . is an undue and unnecessary burden on interstate commerce . . . ." Regrettably, this very act would be later amended to preempt the application of all state laws prohibiting gambling.

Both common and statutory law have been hostile toward the enforcement of gambling contracts for centuries. Yet, consistently with the distinction dating back at least to Aristotle, not all commercial activity involves gambling. American state law, like Aristotle and medieval canonists, has striven to properly distinguish and permit legitimate commerce while prohibiting only wagering and its harmful effects on the public interest. Such an approach requires a technique for distinguishing problematic gambling contracts from legitimate transactions. Courts and state legislatures responding to economic changes worked to refine a metric for drawing the distinction which at its core embodied the same principle as Aristotle—

141. Kelly, supra note 139, at 88.
142. See, e.g., Eldred v. Malloy, 2 Colo. 320, 321–22 (Colo. 1874).
gambling existed where a zero sum game occurred among parties who had no other economic interest in the asset subject to the contingency. The detailed work of drawing the correct lines has focused on distinguishing two major categories of transactions which superficially resemble wagering contracts: insurance (and similar indemnity agreements) and forward sales of goods for future delivery. The principles developed by the courts form a coherent system for protecting legitimate contracts while identifying harmful speculative wagers.

2. Distinguishing Insurance and Indemnity Agreements

The legitimacy of insurance contracts and their distinction from wagering was developed hundreds of years ago. Without much controversy, mere price speculation was distinguished early in the medieval period from contracts of insurance, which were understood to be selling an existing risk for a fixed price. Gambling, in contrast, creates a new risk rather than transferring one. An insurer adds value to the insured assets by removing a pre-existing risk (such as potential destruction of the goods), enhancing the value of those goods for their owner. In contrast to contracts that have a purely speculative purpose, the purpose of insurance contracts is "to compensate for losses suffered—not to generate profits" for the owner of the goods. Two doctrines that remain at "the heart of insurance—the requirement of insurable interest and the indemnity principle—have both evolved, in part, to prevent speculators from using insurance for speculation." Courts have developed

146. See JOHN T. NOONAN, JR., THE SCHOLASTIC ANALYSIS OF USURY 203 (Harvard Univ. Press 1957) ("Thus, without any important opposition whatsoever, the insurance of property was accepted by the theologians.").

147. Stout, supra note 10, at 725.

148. Id. at 724 (citing Warnock v. Davis, 104 U.S. 775, 779 (1881) (holding that a policy held by a party without an insurable interest is unenforceable as "a wager policy, or a mere speculative contract"); arguing that courts have long explained the insurable interest and indemnity doctrines as flowing from the public policy objection to pure speculation); see also Brockway v. Mut. Benefit Life Ins. Co., 9 F. 249, 254 (C.C.W.D. Pa. 1881) (stating that policies purchased by individuals who lack insurable interest are "speculative insurance," and that the law does not sanction insurance "obtained for the purpose of speculaing upon . . . hazard"); Helmetag's Admr v. Miller, 76 Ala. 183, 186 (Ala. 1884) (stating that "wager policies . . . are entitled to no higher dignity, in the eye of the law, than gambling speculations"); Crossman v. Am. Ins. Co. of Newark, N.J., 164 N.W. 428, 429 (Mich. 1917) (finding that "[p]olicies of insurance founded upon mere hope and expectation and without some interest in the property, or the life insured, are objectionable as a species of gambling"); 43 AM. JUR. 2D Insurance § 938 (2013). For an example of modern cases, see Jackson Nat'l Life Ins. Co. v. Reecon, 827 P.2d 118, 130 (N.M. 1992) (noting that a lack of insurable interest "encourage[s] speculation"); see also Scarola v. Ins. Co. of N. Am., 292 N.E.2d 776, 776 (N.Y. 1972) (noting that the reason for
a definition of wagering that incorporates the absence of an insurable interest. The Arizona Supreme Court explained the distinction between insurance and wagering when examining a forward contract for cotton in light of the policy against wagering contracts:

Insurance against fire or other hazards is not a wager, when the insured owns an insurable interest which is subject to risk of such hazard, but, when he owns no such insurable interest a contract in form of insurance otherwise perfect is a wager and is void on that account. Undoubtedly, if appellee had not owned a crop of cotton, and if the parties merely undertook to bet on his judgment in such manner, the contract would not be enforced.

Courts continue to distinguish wagers from insurance by asking if one party had such an insurable interest enforcing contracts containing an insurable interest while refusing enforcement to those lacking it. A recent North Carolina Court of Appeals decision explained that a wager will be found to exist when neither party has any interest in the outcome of the triggering event (other than the wager itself). Courts have explained the insurable interest doctrine by reference to panoply of public policy reasons, including the prevention of the use of insurance contracts to mask gambling or wagering.

Related to the insurable interest doctrine is the doctrine that insurance provides indemnity against actual economic loss. The common law

the insurable interest requirement is that one having no real economic interest in the subject property is making a wagering contract against public policy).

149. See 38 AM. JUR. 2D Gambling § 3 (2014) (citing Westerhaus Co. v. City of Cincinnati, 135 N.E.2d 318 (Ohio 1956)) (defining wagering as “contracts in which the parties in effect stipulate that they will gain or lose upon the happening of an uncertain event, in which they have no interest except that arising from the possibility of such gain or loss.”) (emphasis added).


151. See Wolfram P’ship, Ltd. v. LaSalle Nat. Bank, 765 N.E.2d 1012, 1023 (Ill. App. Ct. 2001), modified on reh’g (Mar. 20, 2002) (holding that, although lack of an insurable interest will ordinarily render an entire insurance policy void and unenforceable as contrary to public policy, where there are several insureds under the policy, and all do not have requisite insurable interest, the policy is invalid only as to those lacking such an insurable interest).

152. See Odell v. Legal Bucks, L.L.C., 665 S.E.2d 767, 774 (N.C. Ct. App. 2008) (holding that defendants provision of funds in connection with plaintiff’s personal injury suit was not a wager because, among other things, plaintiff had an interest in the outcome of the claim).

traditionally would enforce contracts that appeared to be wagers. Payment was contingent upon the occurrence of an event "if one party had some preexisting economic interest in the underlying good that would be damaged by the very same event that would allow it to profit under the contract." This "indemnity" exception to the rule against gambling on future events is still enshrined in modern insurance law, which enforces insurance contracts only to the extent that the policyholder "would suffer an offsetting economic loss from any destructive event that triggered payment under the policy." Recovery under insurance is limited to the extent of the economic value of the insured's interest in property subject to insurance.

In applying the insurable interest and indemnity tests to distinguish insurance from wagering, courts have been sensitive not to enforce a rigid line of demarcation. In some cases, courts have granted some scope to the insured in proving an insurable economic interest capable of being indemnified beyond the simple base case of replacement cost of a destroyed asset such as a house or car. For example, the Court of Appeals of Minnesota held that an economic loss capable of insurance indemnification existed in a rain insurance contract, even though the insurer would pay even if the insured concert was not actually cancelled or postponed. The court explained its reason for recognizing an economic loss thus:

Here, the insurable interest was increased expenses and intangible losses incurred as a result of the rainfall. Affidavits indicated that holding a concert in the rain increased expenses, damaged goodwill, decreased popularity of outdoor concerts, and caused a decline in future ticket sales and acceptance of outdoor concerts.

Although the Minnesota court granted a wide berth to the insured in proving economic loss so as to take account of somewhat intangible losses such as goodwill, the court noted that such leniency had a boundary. The court explained that, when the value of the insurable interest is grossly disproportionate to the insurance payment required, then the contract is void as a wagering contract. Thus, the indemnity doctrine requires not only that the insured hold an insurable economic interest, but that the amount of

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154. See Stout, supra note 3, at 12.
155. Id. at 12.
156. See Stout, supra note 10, at 725.
158. Id.
159. See id. at 443; see also 3 LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 41:2 (3d Ed. 2006) (reiterating the same limitation).
insurance proceeds payable must be proportionate to the economic value at risk.

Beyond granting scope for demonstrating insurable economic loss, courts have been willing to extend the protection of insurance contracts beyond transactions formally structured and documented as such. Contracts that in substance provide for a guaranty against real financial loss were grouped with licit insurance contracts, rather than illicit gambling contracts. Such contracts, often referred to as "hedging contracts," were distinguished from wagering when "one party . . . could demonstrate that the contract served a legitimate hedging function" by demonstrating "that at the time she entered the contract, she held an economic interest that would be damaged by the happening of the very same event that would allow her to profit under the contract . . . Because such a contract would offset a preexisting source of loss rather than creating an opportunity for gain, courts re-characterized these types of contracts as enforceable 'indemnity' agreements." Although technically not insurance contracts, courts acknowledged that contracts entered into for hedging purposes were indistinguishable from insurance contracts in their purpose and were thus enforceable as indemnity agreements. Parties might need to utilize a different form of transaction than a standard insurance contract when the economic risk is not one for which insurance policies exist. One early commentator on the new forms of futures agreements used to hedge risk cites such an example when explaining why it is analogous to insurance contracts:

"[H]edging" is the use of future contracts as a means of insurance against price fluctuation. For example, let it be supposed that a flour mill buys 100,000 bushels of wheat on the cash grain market. In order to protect itself against loss through a drop in the value of the grain it now holds, it immediately sells on the future market 100,000 bushels for delivery in some convenient future month. It is obvious that whatever loss the mill sustains on account of a drop in the value of its stock of wheat will be compensated for by a profit on the "short sale." Subsequently, as the mill disposes of its wheat, it will close out its future contract by counter-transactions, having successfully eliminated the risk incident to price fluctuation during the time it held the actual grain.

Various courts held guaranty or indemnity agreements to be "in the nature of a contract of guaranty insurance and not against public policy" in a variety

161. Id. at 719.
circumstances not typically covered by insurance.163 For example, the Supreme Court of the United States noted that a promise to repurchase subscribed shares at the original purchase price plus 7% "standing by itself, was a perfectly fair and honest one, in which there was no vice inherent that would relieve the person making it from its obligation."164 The Supreme Court of Oklahoma held that a promise by a large stockholder to guaranty the value of other stockholders' stock at a future date was not an unenforceable wager contrary to Oklahoma law because the stockholders who were entitled to payment actually owned the referenced stock and suffered actual loss of value that was indemnified by the payment.165 Courts such as these were willing to evaluate the substance of the transaction rather than its form in order to determine whether an insurable interest underlay a contingent contractual payment. The Supreme Court of Massachusetts explicitly so stated when it held a promise to indemnify a shareholder if the corporation whose stock he owned failed to pay annual dividends at a specified rate.166 The court concluded: "If the contract, in the present case, had been put into the form of a policy of insurance, it is certain that it would not have been a wager."167 As with the leniency shown in allowing parties to demonstrate a wide variety of insurable loss, courts permitted parties to demonstrate the substance of indemnity of an insurable interest without having to utilize the form of an insurance policy.

The contracts in the foregoing cases bear a striking resemblance to modern credit default swaps. Both involve promises of payment contingent upon a certain value of or payment on account of a referenced asset. The line of demarcation between the facts of these cases and CDS contracts is that the courts upholding the former insisted upon actual ownership of the referenced security, whereas CDS contracts do not require the Protection Buyer to own anything. Professor Stout uses the same test as applied by the courts in a prior era to distinguish derivatives serving insurance or hedging purpose from pure wagers. The former transactions involve two hedging parties merely insuring against opposite outcomes or one hedging party contracting with a speculator providing hedging protection.168 On the other hand, in cases where transaction parties trade merely because of differing opinions on price movements with respect to assets neither of them produces or consumes, such a transaction "is
a form of wagering where the gamblers bet on market prices, rather than on the outcome of a card game or sporting contest.” The insurable interest and indemnity tests are consistent with the medieval requirement that legitimate trading actually involve some change to an asset owned by one party to the contract. In the case of insurance or indemnity contracts, the shifting of pre-existing risk constitutes the improvement.

3. Distinguishing Forward Sales from Speculative Wagers

Legislation against mere price speculation dates to at least the ninth century. One thousand years later, in the late nineteenth century, many states observed that the use of a new type of financial contract, commodity futures contracts (or contracts for future delivery) appeared to embody a form of speculative wagering. The courts and legislatures eventually came to view these contracts as a form of wagering, which was void as against public policy, when they were used to speculate on future prices rather than to actually transact in the goods or at least hedge against existing risk.

Commenting on the similarities between the characteristics of futures contracts and general betting contracts, the Georgia Supreme Court stated that “[t]he law has caged [the other betting games such as faro, brag, or poker], and driven them to their dens; they have been outlawed, while this ferocious beast has been allowed to stalk about in open mid-day, with gilded signs and flaming advertisements, to lure the unhappy victim to its embrace of death and destruction.” The court stated that the consequences of allowing these contracts to survive would be found in “bankruptcies, defalcations of public officers, embezzlements, forgeries, larcenies, and death.” Citing to other cases holding similarly, the court observed that these contracts are “contra bonos mores, and against public policy.” Echoing the Medieval jurists’ condemnation of speculative trading, courts of the period argued that purely speculative contracts, like all wagering contracts, were essentially unproductive. Wagering and speculation “promote . . . no legitimate trade” and “discourage the disposition to engage in steady business or labor.”

169. Stout, supra note 10, at 742.
171. See Stout, supra note 10, at 715.
173. Id.
174. Id. at 403–04.
175. See Stout, supra note 10, at 716–17, n.54.
Courts began to develop more particularized assessments of the harmful public policy implications of some futures contracts rather than relying on the general policy against wagering. Through articulation of the precise harms caused by commodity wagering, the courts eventually developed a test to distinguish legitimate sales for future delivery from wagers—the intent to deliver test.

Courts focused their policy analysis on the deleterious effects on the commodities markets, claiming that futures contracts disrupted the “creative market expansion,” which was “so important to the late nineteenth century,” by “luring away important funds and seducing hard-earned capital.” The speculative use of futures contracts in essence drained off capital that otherwise would have been deployed in the production and distribution of the relevant commodity. Courts argued that this harmful drain on capital was not accompanied by any offsetting advantage because there was “no commodity that changed hands” and therefore no benefit to the market. The futures contracts were seen as contributing nothing—and in fact constituting a harmful distraction—to the market. Once again the courts were echoing age-old objections to traders who added no value to assets but merely extracted profits. Courts argued: “[M]en . . . . were not meant to waste time with futures investments that were at best a distraction from honest work and at worst potentially ruinous.”

The Pennsylvania Supreme Court, in Kirkpatrick & Lyons v. Bonsall, commented upon the harmful effects of widespread wagering in commodity prices on the market for such commodities. Since the wagering contracts did not require a “bona fide intent to deal in the article,” the court reasoned that these “wagers” encouraged “men of small means to enter into transactions far beyond their capital, which they do not intend to fulfill, and thus the apparent business in the particular trade is inflated and unreal.” Therefore, “like a bubble [it] needs only to be pricked to disappear; often carrying down the

179. A similar observation has been made concerning the diversion of capital from production when usurious lending is permitted. See Brian M. McCall, The Church and the Usurers: Unprofitable Lending for the Modern Economy 73 (2013).
180. Lurie, supra note 178, at 63.
182. 72 Pa. 155 (Pa. 1872).
183. Id. at 158.
184. Id.
bona fide dealer in its collapse."\textsuperscript{185} Such an assessment could be put into the mouth of a modern commentator on the pre-2008 unrestrained derivative market.\textsuperscript{186} The court went further to claim that "worse even than this, it tempts men of large capital to make bargains of stupendous proportions, and then to manipulate the market to produce the desired price."\textsuperscript{187} An identical comment could have been made with respect to the Magnetar Trade.\textsuperscript{188} Late nineteenth century common law courts could clearly see what late twentieth century regulators had forgotten—that the presence of pure wagers inflated the apparent size of the actual market, thereby distorting the market and encouraging market manipulation to achieve desired pricing and avoid massive capital loss when a bubble burst. The Pennsylvania court worried that if these contracts were valid, the "poor [would be] robbed, and misery [would be] engendered."\textsuperscript{189} Similar concerns can be found in decisions and commentaries throughout the state courts.\textsuperscript{190}

The Illinois Supreme Court in \textit{Cothran v. Ellis} echoed the Pennsylvania Supreme Court's concerns that gambling distorted the market for commodities. Since wagering contracts lacked a "commodity that changed hands,"\textsuperscript{191} the court noted that, "[t]hrough its instrumentality the laws of supply and demand have been reversed, and the market is ruled by the amount of money its manipulators can bring to bear upon it."\textsuperscript{192} This conclusion resembles Aristotle's observation that speculation for profit involves no natural limit since it is detached from real assets. The court went on to regard the dealings in futures contracts as a "national sin," stating that in "its proportions and extent it is immeasurable" and that "[w]ith despotic power it

\textsuperscript{185} \textit{Id.}

\textsuperscript{186} \textit{See e.g., supra} text accompanying notes 122–25.

\textsuperscript{187} \textit{Kirkpatrick,} 72 Pa. at 158.

\textsuperscript{188} \textit{See supra} text accompanying notes 40–41.

\textsuperscript{189} \textit{Kirkpatrick,} 72 Pa. at 159.

\textsuperscript{190} H. S. Irwin, \textit{Legal Status of Trading in Futures,} 32 U. ILL. L. REV. 155, 156 n.7 (1937–38) (stating that the public disdain for such contracts was found in the fact that "there is the temptation for a man to risk more than he can afford, sometimes with disastrous results to himself and his dependents"). The courts in Illinois also commented on the concern that ordinary citizens outside of the financial elite would be harmed by entering into these contracts. Colderwood v. McCrea, 11 I11. App. 543, 547 (1882). In \textit{Colderwood,} the court described the nature of these future contracts, requiring little up-front capital in order to invest in the security, thus luring those with lesser financial stability. \textit{Id.; see also} Pearce v. Foote, 113 I11. 228, 239 (1885) (stating that "[c]onsiderable fortunes secured by a life of honest industry have been lost in a single venture in 'options.' The evil is all the more dangerous from the fact it seemingly has the sanction of honorable commercial usage in its support.").

\textsuperscript{191} \textit{LURIE, supra} note 178, at 63.

\textsuperscript{192} \textit{Cothran v. Ellis,} 16 N.E. 646, 648 (Ill. 1888).
levies tribute upon all trades and professions.” The court held the dealings to be “not only contrary to public policy, but it [was] a crime, a crime against the state, a crime against the general welfare and happiness of the people, a crime against religion and morality, and a crime against all legitimate trade and business.” Lastly, the court declared that “[it] defies alike the laws of God and man.”

The conclusions of the Pennsylvania and Illinois courts, among others, accord with the philosophical objections to price speculation dating back to Aristotle’s observation of the harm of an infinite appetite for profit. Their observations about the distortion of the market follow from the unlimited ability of gamblers to place bets unconstrained by the amount of assets in the market. Since wagering on prices is not limited by the actual amount of the assets bet upon, it involves no natural limit to the amount at risk. Running through the articulation of the harmful effects of speculation is the recognition that gamblers have no interest, nor intent to actually deal, in the referenced assets. This common thread gave birth to the intent to deliver test which provides some anchor to the reality of the underlying assets involved in futures contracts.

Many legislatures of the time shared the courts’ observations on the harm that wagering did to the market for commodities. Concern for market distorting effects was voiced in a 1926 hearing before the United States Senate Committee on Agriculture and Forestry. When considering a bill to prevent the sale of cotton and grain in futures markets, Senator Caraway commented on the effects of the futures market on normal farmers and

193. Id.; see also Lemonius v. Mayer, 14 So. 33, 35 (Miss. 1893) (discussing the “evil” of speculative futures contracts for purposes of interpreting a statute prohibiting them).
195. Id.
196. See, e.g., Ascher & Baxter v. Edward Moyse & Co., 57 So. 299, 303 (Miss. 1912) (discussing the “evils” affecting those using futures contracts and stating that “[t]he withering, blighting curse of these speculations has lured the rich and the poor, the princely merchant and the impecunious clerk, the erstwhile honest and trusted employee” as well as arguing that “[t]he dealing in futures is the begetter of poverty, the companion of embezzlement, the associate of degradation, and it scourges every one whom it touches. Its thirst is unquenchable; its maw insatiable. Its baneful influences have become ... destructive to the legitimate business interests of the country.”). Four years after Ascher, the Mississippi Supreme Court again commented that “[t]he curse of futures contracts is still blighting many an innocent home, and bringing to the innocent members of the family tears of sorrow and despair.” Cohn v. Brinson, 73 So. 59, 62 (Miss. 1916).
197. See supra text accompanying note 102.
producers of cotton. The Senator stated that, while living in a state (Arkansas) with a “good many large [cotton] plantations,” he could count “on the fingers of one hand, those who have been successful,” as a result of the harm caused by the futures markets. Commenting further on the impact to investors in the futures market, Senator Caraway continued:

I have never talked with anybody who actually tried the market, who has not reached that conclusion, that it is a pure gamble. . . . I have been retained to represent a man who lost $50,000 in trying to apply this market to hedge legitimate deals, and he insists it was a pure gambling device and that they lost his money.

Many state legislatures enacted statutes making futures contracts void, and even imposing criminal liability on parties to them. Thus, although Professor Stout is correct in claiming that the common law generally made wagers void, not illegal, state statutory law often supplemented the common law by criminalizing the same unenforceable transaction. The statute employed by the Illinois State Legislature was typical, and with the presence of the Chicago Board of Trade, perhaps the most litigated. The statute read:

Whoever contracts to have or give to himself or another the option to sell or buy, at a future time, any grain, or other commodity . . . . shall be fined not less than $10 nor more than $1000, or confined in the county jail not exceeding one year, or both; and all contracts made in violation of this section shall be considered gambling contracts, and shall be void.

Yet, although this Illinois statute, as well as similar ones enacted across the country, attempted to prohibit the work of a “gambler” on the market, they were worded so broadly that they applied not only to gambling contracts but also to contracts related to the organized trading of actual commodities. Many commentators of the period produced extensive work demonstrating

199. Id. at 31.
200. Id. at 38.
201. Id. at 39.
202. See T. HENRY DEWEY, LEGISLATION AGAINST SPECULATION AND GAMBLING IN THE FORMS OF TRADE 15–49 (Baker, Voorhis & Co. 1905) (examining multi-state survey of twenty-four jurisdictions’ legislation against speculation or against gambling in the forms of trade); see also Legislation Affecting Commodity and Stock Exchanges, supra note 162, at 917–18 nn.26–27 (identifying those jurisdictions with legislation against futures contracts and bucket-shops).
203. Stout, supra note 3, at 14.
204. ILL. REV. STAT. ch. 38 § 130 (1874).
205. See DEWEY, supra note 202, at 15–49.
206. Irwin, supra note 190190, at 156.
the over-inclusive nature of failing to take into account this "real" distinction between gambling and actual buying and selling of commodities; they opined that "a failure to recognize it causes great confusion in much of the legislation and in many judicial decisions." The resulting over-inclusiveness of the prohibition needed to be refined. At a time when courts and legislatures functioned in a dialectical relationship of law making, the common law courts interpreted and thereby limited the application of these statutes in light of the common law acceptance of indemnity contracts, as well as the emerging intent to deliver test for futures contracts.

The difficulty faced by courts in locating this distinction between gambling and legitimate futures contracts was due to the fact that traders and gambling speculators appeared to be engaging in the same types of transactions. The contractual object of the gambler and the hedging party appeared to be identical—to receive payment based upon a "difference between prices." The distinction between the two market actors was that the legitimate forward selling or hedging party "makes his profit [from] the prices of actual purchases and sales, whereas, the gain of the gambler is the difference between the prices of fictitious or pretended purchases and sales." Courts and commentators alike began to develop this distinction by focusing on the fact that in many futures transactions the commodity never actually changed hands. This lack of actual exchange of goods, they argued, made these so called "difference contracts" equivalent to wagers, since the parties merely agreed to pay the difference between the contract price and the market price at the time of settlement.

The U.S. Supreme Court explained the rule against difference contracts in terms of the public policy denying enforcement to wagering contracts thus:

[I]f, under guise of such a contract [a futures commodity contract], the real intent be merely to speculate in the rise or fall of prices, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole

207. DEWEY, supra note 202, at 8; see also Irwin, supra note 190, at 156.
208. DEWEY, supra note 202, at 7, 9–10 (identifying the difference between the speculator and the gambler and stating that it is "indeed difficult to make much of a practical distinction").
209. Id. at 7.
210. Id.
211. See Cohn v. Brinson, 73 So. 59, 62 (Miss. 1916).
transaction constitutes nothing more than a wager, and is null and void.\textsuperscript{213}

Courts found "difference contracts" not tied to an actual delivery of goods to be no more than a form of wagering and observed that their harmful effects were analogous to those of wagering in other contexts. One early twentieth century commentator on the speculative use of futures contracts reached the same conclusion as Professor Stout in the early twenty-first century with respect to speculative derivative contracts—such uses result in "no social gain."\textsuperscript{214} In an analysis that is analogous to the requirement that the party being indemnified under an insurance or hedging contract actually own property causing the indemnified harm,\textsuperscript{215} courts reasoned that, when the parties to a contract for future delivery of goods agree amongst themselves to settle the contract solely by a price set-off, in which no assets are exchanged, there is "no essential difference between the effect of such contracts and that of a wager."\textsuperscript{216} Requiring a bona fide "intent to deliver" the underlying assets appeared to address the same concerns as the insurable interest and indemnity doctrine.

For the court in \textit{Cothran v. Ellis},\textsuperscript{217} the factual link between certain futures contracts and other forms of gambling was constituted by the lack of a "commodity that changed hands."\textsuperscript{218} Yet, distinguishing between speculative contracts for difference and contracts for the future sale of a commodity was very difficult since the two transactions were "close cousins."\textsuperscript{219} Courts could not distinguish between the two types of transactions by simply reading the applicable documentation because in most cases the contracts appeared to require actual delivery, or at least the possibility of it.\textsuperscript{220} Yet, in reality, an overwhelming majority of these contracts never actually resulted in physical delivery.\textsuperscript{221} Instead, the performance of many contracts involved a party

\begin{itemize}
  \item \textsuperscript{213}Irvin v. Williar, 110 U.S. 499, 508–09 (1884).
  \item \textsuperscript{214}Irwin, \textit{supra} note 190, at 156 n.7 (stating that "there is not a gain to both parties in gambling contracts as there commonly is in other contracts"); Stout, \textit{supra} note 10, at 706–07.
  \item \textsuperscript{215}See \textit{supra} Part III.B.2.
  \item \textsuperscript{216}Irwin, \textit{supra} note 190, at 156.
  \item \textsuperscript{217}16 N.E. 646 (111. 1888).
  \item \textsuperscript{218}LURIE, \textit{supra} note 178, at 63; see also Stout, \textit{supra} note 3, at 11 (describing the delivery requirement rule).
  \item \textsuperscript{219}Stout, \textit{supra} note 10, at 714.
  \item \textsuperscript{220}See Telford Taylor, \textit{Trading in Commodity Futures—A New Standard of Legality?}, 43 YALE L.J. 63, 65–66 (1933) (stating that "if such a contract meant what it said, there was no question about its validity").
  \item \textsuperscript{221}See DEWEY, \textit{supra} note 202, at 9 (stating that courts have found in about 95% of cases that actual delivery was not intended, the author commented that perhaps 99% was a "more correct estimate"); Irwin, \textit{supra} note 190, at 157 (stating that "nearly all the contracts are settled

bargaining for a release from the obligation of actual delivery in exchange for a set-off in pricing.222

Since the contracts often appeared indistinguishable in language, courts developed the nuanced requirement that intent to deliver must be found in the transaction circumstances.223 In the absence of such intent to deliver, many courts held the transactions to be void gambling contracts.224 This test left courts to determine "what sort of 'delivery,' and what degree of 'intent to deliver,' will suffice to remove these dealings from the category of unenforceable contracts."225

by offset rather than by delivery on the contracts”); Legislation Affecting Commodity and Stock Exchanges, supra note 162, at 913 (stating that “the great majority of transactions between brokers result in no delivery of the goods contracted for, nor is it open to question that delivery is very rarely intended”).

222. Irwin, supra note 190, at 156; see also Taylor, supra note 220, at 66.

223. Taylor, supra note 220, at 66 (stating that this test was developed by the Court of Common Pleas in 1852).

224. See Clews v. Jamieson, 96 F. 648, 653 (7th Cir. 1899) (“[A] contract for the sale of goods to be delivered at a future day is valid . . . but such a contract is only valid when the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer, and, if under guise of such a contract, the real intent be merely to speculate in the rise and fall of prices, and the goods are not to be delivered . . . , then the whole transaction constitutes nothing more than a wager, and is null and void.”) (citation omitted) (internal quotation marks omitted); J.B. Lyon & Co. v. Culbertson, Blair & Co., 83 Ill. 33, 38–39 (1876) (“A contract, to be thus settled, is no more than a bet on the price of grain during or at the end of a limited period. If the one party is not to deliver or the other to receive the grain, it is, in all but name, a gambling on the price of the commodity, and the change of names never changes the quality or nature of things. It has never been the policy of the law to encourage, or even sanction, gaming transactions, or such as are injurious to trade, or are immoral in their tendency.”); Pickering v. Cease, 79 Ill. 328, 329 (1875) (“[The grain] was not paid for, nor was it expected by the parties it would be called for or delivered. The parties were merely speculating in differences as to the market values of grain on the Chicago market. Such contracts are void at common law, as being inhibited by a sound public morality.”); Gregory v. Wendell, 40 Mich. 432, 439 (1879) (holding that both parties must share intent to not deliver goods before contract will be found void); Falk v. J. N. Alexander Mercantile Co., 102 So. 843, 843 (Miss. 1925) (“A contract for the purchase or sale of a commodity of any kind, to be delivered at a future date, the parties not intending that the commodity is to be actually delivered in kind and the price paid, shall not be enforced by any court; nor shall any contract of the kind commonly called 'futures' be enforced.”); State v. Clayton, 50 S.E. 866, 866–67 (N.C. 1905) (“No matter however explicit the words in any contract which may require a delivery, if in fact there is no intention to deliver, but the real understanding is that at the stipulated date the losing party shall pay to the other the difference between the market price and the contract price, this is a ‘gambling’ contract and is null and void at common law.”); Kirkpatrick v. Bonsall, 72 Pa. 155, 159 (1872) (“If this purpose or intent be nothing but to wager on the rise or fall in the price of an article, and not to deal in it bona fide, the law must pronounce the bargain a gambling contract.”).

225. Legislation Affecting Commodity and Stock Exchanges, supra note 162, at 913.
As the “intent to deliver” test developed, courts generally began with the presumption that the contract is valid. Thus the burden would be placed on the challenger to prove that the contract was intended for wagering rather than for hedging purposes. To meet this burden, the challenger could present testamentary and documentary evidence to persuade the court that the true intentions of the parties render the contract invalid. Although compliance with the rules of the cotton exchange and an appearance of validity on the face of the contract were given much weight, courts would scrutinize evidence of the parties’ course of dealing to overcome the presumption of validity.

In Jennings v. Morris, the Supreme Court of Pennsylvania reviewed a claim made by a cotton broker against manufacturers of cotton. Over the course of several years, the defendant-manufacturers ordered thousands of bales of cotton, which plaintiff filled. But a decline in the market price of cotton, combined with the defendants’ failure to provide sufficient margins, resulted in a loss for the plaintiff, for which he sought recovery from defendants. The defendants combated his claims by alleging that the contract was invalid because it was intended as an illegal gambling contract. To determine the intent of the parties, the court first considered the testimony of the parties. But because the testimony was contradictory, the court turned its focus to documentary evidence. Throughout the parties’ dealings, the plaintiff-broker regularly sent letters to the defendant-manufacturers regarding their orders. These letters explicitly stated that actual delivery was understood and intended. Although the transaction

228. See Bailey & Graham, 159 F. at 538–39.
229. Id. at 539.
231. Id.
232. Id.
233. Id.
234. Id.
235. Id. at 115–16.
236. Id. at 116.
237. Id. At the time this case was heard, the well-accepted standard for determining whether the parties in similar cases intended to hedge or gamble was to demonstrate that the parties intended actual delivery of the underlying product. See Clews v. Jamieson, 96 F. 648, 653 (7th Cir. 1899); J.B. Lyon & Co. v. Culbertson, Blair & Co., 83 Ill. 33, 36 (1876); Pickering v. Cease, 79 Ill. 328, 329 (1875); Gregory v. Wendell, 40 Mich. 432, 439 (1879); Falk v. J. N. Alexander Mercantile Co., 102 So. 843, 843 (Miss. 1925); State v. Clayton, 50 SE. 866, 866 (N.C. 1905); Kirkpatrick v. Bonsall, 72 Pa. 155, 159 (1872). Although this standard was later called into
appeared to be legitimate on its face, the court identified the shortcomings of this evidence of intent. Specifically, the court noted that the parties, having dealt regularly in these transactions and therefore knowing that validity requires intention to deliver, may have used this language in an attempt to "cover the illegality by a seeming legal contract." Alternatively, the court reasoned that, even if the parties initially intended actual delivery, they may have abandoned this intent in their course of dealing. The court ultimately determined that this evidence alone was not dispositive. To determine the true intent of the parties, the court looked beyond the face of the agreement and into the parties' course of dealing. The defendant-challengers offered the plaintiff's bills for cotton as evidence of a seeming shift in the intentions of the parties in the midst of their course of dealing. For those orders that the defendant-challengers conceded were legitimate, the bills contained notations that indicated the amount or weight of the bales sold, plans for delivery, and terms of payment. The court determined that, in a legitimate transaction, this information would serve as a means by which the buyer could confirm the accuracy of his order when he received the delivery. The bills for the disputed transactions did not contain this information. The court agreed that the absence of this information on the latter transactions indicated that the parties never intended to deliver on the orders. Thus, the court concluded that the intention behind the disputed transactions was different than the intention behind the legitimate orders. Based on the parties' course of dealing, the court held the contract to be unenforceable as a matter of public policy.

The Supreme Court of Arkansas considered a factually similar case in Johnson v. Miller. Here, the plaintiff-broker brought suit against a question by Board of Trade v. Christie Grain & Stock Co, 198 U.S. 236, 248-49 (1905), the Jennings case still demonstrates the court's ability to analyze the evidence to determine whether the contract was intended for gambling or hedging purposes.

239. Id.
240. Id.
241. Id.
242. Id. at 115.
243. Id.
244. Id.
245. Id.
246. Id.
247. Id.
248. Id.
249. Id. at 115-17.
250. 53 S.W. 1052 (Ark. 1899).
wholesale grocer who refused to pay for services rendered. As in Jennings, the defendant-challenger claimed that the agreement was an invalid gambling contract. In determining the validity of the contract, the Johnson court underwent an analysis similar to that of the Jennings court. Neither the testimony of the parties nor the terms of the agreement, which was documented by telegraph communications, demonstrated that the intentions underlying the transaction were merely to wager on the price of cotton. The court focused on the conduct of the parties. But unlike in Jennings, the defendant-challenger in this case failed to offer any evidence demonstrating that the plaintiff's intent was anything other than to sell cotton in the future in accordance with the rules and regulations of the New York Cotton Exchange. After scrutinizing a variety of evidence, the court concluded that the facts offered no clear proof of an illegal intention on behalf of the plaintiff.

Although differences between these cases exist, including the outcomes, the relationships between the parties, and the evidence offered, the analyses conducted by the courts are essentially the same. The courts gave the defendant-challengers the opportunity to rebut the presumption of validity with evidence of illegal intentions. Both courts looked to testamentary and documentary evidence to gain insight into the agreements and course of dealings between the parties. The courts were well-positioned to look beyond the superficial terms of the agreements to determine whether or not the contracts were intended for wagering or legitimate purposes. By allowing courts to review the validity of these contracts in light of public policy opposition to wagering contracts, rather than requiring a blanket prohibition or permission of all such contracts, society is able to meet two important objectives simultaneously—market participants are able to avail themselves of the benefits of legitimate hedging and courts are able to protect society from the harms occasioned by wagering contracts.

Unfortunately the Supreme Court of the United States intruded into this developing state law jurisprudence in applying the "intent to deliver" test by creating an escape hatch for would-be-gamblers. In the absence of criminal statutes, the legal consequence of engaging in a "difference contract" found to be wager was simply preclusion from enforcement of the gambling

251. Id. at 1052, 1054.
252. Id. at 1053.
253. Id. at 1054–55.
254. Id.
255. Id. at 1056.
256. Id. at 1055.
contract. Private mechanisms emerged to facilitate gambling in a shadow outside the law of legally enforceable contracts. Contracts were made through clearinghouses which provided private guarantees of their enforcement in lieu of recourse to the closed courthouse doors. In the absence of criminalizing statutes, this financial gambling continued outside the enabling arm of the law, in private gambling parlors known as exchanges, which were open only to those willing to forego legal enforcement and trust the private exchange operators. Such legal uncertainty must have deterred more widespread use of these private mechanisms since their use involved the added transaction costs of potential settlement failure without recourse to the courts. But the U.S. Supreme Court stuck its nose into state law and ordered state courts to enforce gambling executed through one of these private exchanges. In Board of Trade v. Christie Grain & Stock Company, Justice Oliver Wendell Holmes ruled that “a set-off is, in legal effect, a delivery.” Settlement by set-off in a clearing system or exchange was thus transformed into the equivalent of delivery of the underlying asset. Professor Stout summarizes the effect of this “stunning victory” for the exchanges thus:

Speculative difference contracts entered into off the exchanges in the “over-the-counter” (OTC) market were void under the common law and were possibly criminal under state antibucketshop laws. On the exchanges, however, speculative trading in futures was not only permitted; futures contracts were legally enforceable because set-off was deemed a “delivery.”

State courts were bound to enforce “difference contracts” made on an exchange that allowed for set-off of mirror contracts. The Supreme Court exempted wagers made on private exchange from the developing intent to deliver test.

The effect of sanitizing exchange traded futures contracts was ameliorated somewhat by the adoption of the Grain Futures Act of 1922, reenacted in 1936 as the Commodity Exchange Act (“CEA”). With the adoption of this statute, the federal government began regulating the exchanges. Thus,
although exchange gambling was made legally enforceable, it was at least subject to some constraint under a variety of regulations limiting its scope. In order to prevent “excessive speculation,” the CEA authorized the Commodity Futures Trading Commission (“CFTC”) to adopt position limits to restrain the volume any one gambler could place on any one product. In addition, a provision of the CEA (repealed in more recent times) required review of contracts to be traded on exchange for consistency with the “public interest.” The CFTC had interpreted this public policy to mean that the contract must serve some economic purpose other than pure speculation. Finally, federal law reinforced what was left of state law by making it illegal as a matter of federal law to enter into any futures contract off an exchange (i.e. in an OTC market) unless the parties intended to make delivery of the underlying article and the transaction was entered into for hedging purposes. Although the law as developed by state courts and legislatures was now constrained to applying the intent to deliver test only to OTC contracts, federal law at least imposed some restraints on unbridled gambling on the exchanges.

Following Christie, although states had to accept wagers made on privately owned exchanges, courts and legislatures continued the legal battle to control wagers off-exchange. Legislatures and courts tended to work in tandem to develop the law against financial wagering and to respond to changes in the market. The panic of 1907 was viewed as having been caused in large part by wagering on the stock market in so called bucket shops. The bubble-producing effect of bucket shops in the period leading up to the 1907 crash is strikingly similar to the effects of credit default swaps on the mortgage market prior to the recent financial collapse. On the heels of the 1907 panic, New York adopted a bucket shop statute prohibiting the enforcement of stock market wagers. This statute, and those of other states, enshrined in statutes a stronger version of the common law rule that futures contracts that did not intend delivery of the underlying asset were

266. See Stout, supra note 3, at 18.
267. See text accompanying supra note 141.
268. See Sapien, supra note 143.
unenforceable gambling contracts. Some versions went beyond the common law and imposed criminal sanctions. The current version of the New York bucket shop law defines the prohibited activity in relevant part as follows:

Any person ... who shall: 1. Make ... any contract respecting the purchase or sale, either upon credit or margin, of any securities or commodities, including all evidences of debt or property and options for the purchase thereof, shares in any corporation or association, bonds, coupons, scrip, rights, choses in action and other evidences of debt or property and options for the purchase thereof or anything movable that is bought and sold, intending that such contract shall be terminated, closed or settled according to, or upon the basis of the public market quotations of or prices made on any board of trade or exchange or market upon which such commodities or securities are dealt in, and without intending a bona fide purchase or sale of the same; or, 2. Makes ... any contract respecting the purchase or sale, either upon credit or margin, of any such securities or commodities intending that such contract shall be deemed terminated, closed and settled when such market quotations of or such prices for such securities or commodities named in such contract shall reach a certain figure, without intending a bona fide purchase or sale of the same; or, 3. Makes ... any contract respecting the purchase or sale, either upon credit or margin of any such securities or commodities, not intending the actual bona fide receipt or delivery of any such securities or commodities, but intending a settlement of such contract based upon the difference in such public market quotations of or such prices at which said securities or commodities are, or are asserted to be, bought or sold; 

This legislative definition of prohibited contracts, dating from 1965, echoes the “intent to deliver” test. As recently as 1993, courts have interpreted this language accordingly. In Salomon Forex, Inc. v. Tauber, the Fourth Circuit found that foreign currency option and future transactions did not violate New York’s bucket shop statute because they represented bona fide contracts containing legal obligations to deliver currency. The court quoted explicitly the statute’s language “without intending a bona fide purchase or sale of the same; or, 2. Makes ... any contract respecting the purchase or sale, either upon credit or margin of any such securities or commodities, not intending the actual bona fide receipt or delivery of any such securities or commodities, but intending a settlement of such contract based upon the difference in such public market quotations of or such prices at which said securities or commodities are, or are asserted to be, bought or sold;”

269. See Stout, supra note 10, at 721.
270. See id.
271. N.Y. GEN. BUS. LAW § 351 (McKinney 1975) (emphasis added).
purchase or sale."

In affirming the district court, the Fourth Circuit noted that these contracts “were not settled by reference to the dealings of others, but by further trading between the parties, who engaged in offsetting transactions” to fulfill their legal obligation to deliver currency.

Because of the potential for misuse, cotton futures contracts must be analyzed under state “bucket shop” laws, which prohibit wagers based solely on price, while permitting legitimate contracts made for hedging purposes.

The intention behind futures contracts is oftentimes not readily apparent. The same is true of CDS. But unlike CDS, there is no federal statute prohibiting all claims challenging the validity of a contract for future delivery of cotton on the basis that it is intended as a wagering contract. Rather, the courts are charged with the task of deciphering the true intent of the parties in entering into these contracts.

Due to federal preemption of all state law for CDS, including the bucket shop statutes, there are no cases applying bucket shop laws or the intent to deliver test to CDS. Yet, it would seem likely that at least naked credit default swaps, when the parties had no insurable interest nor intent to deliver, would be found to be void wagering contracts if state law were permitted to operate.

New York’s bucket shop law is explicitly applicable to “bonds, coupons . . . and other evidences of debt . . . and options for the purchase thereof.” But for the federal preemption, courts applying these statutes and the general common law prohibition on wagering would be ready to sort out the wheat from the chaff of the CDS market. Yet, the hands of courts have been tied by federal statutes that have enabled the explosion of an unregulated

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273. Id. at 978.
274. Id.
277. Williston’s analysis of bucket shop transactions as pure gambling could equally be applied at least to naked credit default swaps: “There is no question that the dealings of a so-called ‘bucket shop,’ in which market prices are used as a basis for the settlement of differences on sham ‘purchases and sales’ and in which no delivery is ever made or expected, are gambling. This is because the parties cannot, under the guise of a contract that has the appearance of validity, make a valid contract when the real intention is merely to speculate on the rise and fall of the market without any purpose that any property is to be delivered or received, but with the understanding that, at the appointed time, the account is to be adjusted by paying or receiving the difference between the contract and the current price.” Lord, supra note 129, at § 17:12.
CDS market. The next Section turns to consider the history of the federal quarantine of state law.

C. The Legal Free Ride for CDS Before and After the Crisis

As I argued elsewhere, the best way to develop human law is through a dialectical interaction of general natural law principles, developing case law and targeted statutory enactments.\(^\text{278}\) The alternative use of comprehensive preemptive statutes that attempt to address entire areas of law produces a vast volume of rules, but undermines the purposes of law and creates disrespect for the law itself.\(^\text{279}\) In the preceding Section, we considered the law regarding wagering as a case study of the dialectical development of law. The general natural law principle against price speculation was made concrete through court decisions addressing new forms of contracts. Methods of distinction were developed to distinguish insurance, indemnity and hedging contracts from mere price speculation. Courts developed and refined the insurable interest, the indemnity principle and the intent to deliver test, to grant sufficient scope for legitimate trade and hedging, while refusing to enforce wagers. State statutes interacted in targeted ways to reinforce developing case law by making new direct applications of the common law tests (as in the bucket shop laws) or extending the remedy for wagering beyond lack of enforcement. Although the Supreme Court arrested some of this development by sanitizing exchange-traded contracts, federal statutory law in the form of the CEA initially reaffirmed state law principles by making off-exchange wagering illegal and unenforceable and by adopting measures to limit on exchange trading to reduce excessive speculation. Decades later, federal law would aggressively eviscerate entirely the jurisdiction of state law, although the Dodd-Frank Act did turn back the regulatory clock somewhat. This Section will summarize this federal statutory preemption of the ongoing development of the legal restraint on financial gambling. This Section will conclude with a summary of the current state of regulation of credit default swaps as a result of this turbulent history.

The first swap agreements appeared in the late 1970s or early 1980s.\(^\text{280}\) When credit default swaps were first developed in the 1990s their initial use seemed to have created a mechanism for banks to allocate and transfer loan

\(^{278}\) See McCall, supra note 9.
\(^{279}\) Id.
default risk. As we have seen, this initial use expanded to include speculative trading. The dual purpose use of CDS contracts led to regulatory jurisdictional issues. Notwithstanding at least some CDS similarity to insurance, CDSs have not been regulated as insurance. Exemption from insurance law was made legally certain in New York in 2004. The insurance law was amended to read bluntly: "the making of [a] credit default swap does not constitute the doing of an insurance business." CDSs were exempt from insurance prudential regulation (including capital reserve requirements). Several other states followed New York by amending their insurance law to exempt credit default swaps. Although one use of CDSs is analogous to obtaining insurance against loan default, insurance law has left the contracts unregulated. Following the financial crisis, New York narrowed this exception to an extent by requiring some, but not all, CDSs to be treated as insurance products for regulatory purposes. The new treatment only applies to CDSs which are purchased "by a party who, at the time at which the agreement is entered into, holds, or reasonably expects to hold, a 'material interest' in the referenced obligation." Thus, speculative purchases of CDS contracts by buyers not holding an interest in the reference obligation remain subject to the 2004 exemption from insurance law.

The use of CDSs to speculate on debt instruments caused many in the industry to be concerned that they could be considered gambling contracts. Following pressure from the derivatives industry, Congress exempted swaps from "any State or local law that prohibits or regulates gaming or the operation of 'bucket shops' (other than antifraud provisions of general applicability)." The preemption applied to any transaction exempted from the CEA. In the same law, Congress granted the CFTC the explicit

281. See Sapien, supra note 127, at 425.
282. See text accompanying supra notes 73–68.
285. Id.
286. See Schwartz, supra note 59, at 173.
288. Insurance Dept., supra note 287.
289. Dinallo, supra note 3.
290. See Stout, supra note 3, at 19.
292. Id.
authority to exempt any "agreement, contract, or transaction" from the CEA. Shortly after passage of the law, the CFTC used its new authority to exempt swap transactions, granting a formal regulatory confirmation of its intention not to regulate swaps, which had been announced in 1989. Congress and the CFTC, under pressure from the industry, exempted swaps from almost all federal and state law. Exempt swaps were freed from required exchange trading and could be enforced in state court as legal transactions, notwithstanding state statutes and common law rules treating at least the speculative uses of swaps as illegal gambling contracts. At the time that the industry was lobbying for complete sterilization of all laws controlling the use of financial products for widespread gambling, Professor Stout had the sense to call such a move a "radical departure from legal tradition . . . . overruling law that dates back not just decades, but centuries." Although at the time the exemptions enabled mostly interest rate swaps, the legal get-out-of-jail-free card was in place once credit default swaps emerged a few years later. Ironically, Congress declared that this reversal of longstanding legal principles was done "in order to promote responsible economic or financial innovation and fair competition."

In the wake of several major bankruptcies or near financial collapses, the CFTC announced that it was considering reversing course and regulating financial derivatives. The derivatives industry launched full opposition and decisively defeated the potential repeal of federal deregulation and state law preemption in the Commodity Futures Modernization Act of 2000 ("CFMA"). The final law "emerged out of closed-door negotiations" and was signed by President Clinton seven days after its introduction in Congress and without any changes. Notwithstanding the "sweeping changes"

293. Id. § 502(a) (amending 7 U.S.C. § 6).
295. Id. The statute not only referenced "bucket shop" statutes but "any State or local law" thus exempting State common law as well. See supra text accompanying note 291.
296. See Stout, supra note 10, at 768.
299. See Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,115 (May 12, 1998) (to be codified at 17 C.F.R. pts. 34–35) (announcing an intention to begin regulating such derivatives as subject to the CEA); Stout, supra note 3, at 1920; Stout, supra note 10, at 767 (describing the CFTC release making this announcement).
300. See Stout, supra note 3, at 20–21.
contained in the CFMA, it was adopted with "little legislative history." The mobilized derivatives industry won similar victories abroad when, at about the same time, the United Kingdom overturned its own centuries long prohibition of speculative "difference contracts."

To guarantee legality for the speculative uses of CDSs and other derivatives, the CFMA transformed the regulatory exemption by the CFMA from the CEA into a legislative exemption of virtually all financial derivatives contracts, which were now free to trade off-exchange (the OTC market). This provision removed the discretion of the CFTC to decide if various derivatives should be regulated under the CEA. Beyond the CEA, the CFMA also expressly exempted swaps from regulation under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). In addition, the CFMA expanded and confirmed the preemption of state law. The statute repeated the explicit preemption of state law against gambling or bucket shops and added a provision declaring that "no covered swap agreement shall be void, voidable, or unenforceable . . . under any provision of Federal or State law, based solely on the failure of the covered swap agreement to comply with the terms or conditions of an exemption or exclusion from any provision of the Commodity Exchange Act or any regulation of the Commodity Futures Trading Commission." To guarantee absolute certainty of the enforceability of derivatives such as CDSs, not only were they exempted from the law, but, if for any reason, they were found to be subject to the CEA and failed to comply with any requirements for exemption, they could never be held void or unenforceable. One commentary explained the intent of Congress was "to provide these facilities that trade [derivatives] with a choice. If regulation is beneficial, the facility may choose to be regulated. If it is not, the facility may choose to be

302. PHILIP McBRIDE JOHNSON & THOMAS Lee HAZEN, COMMODITY REGULATION, SPECIAL SUPPLEMENT: AN OVERVIEW OF THE COMMODITY FUTURES MODERNIZATION ACT 4 (3d ed., Aspen Publishers, Inc. 2002); see also id. at 40 ("There has been no change in the legal landscape within the derivatives law field as sweeping in scope and effect as the CFMA.").


305. See Sjostrom, supra note 283, at 983–85. The exemption did permit the application of anti-fraud provisions of general applicability contained in the Securities Act and the Exchange Act. Id. at 985.


307. Id. § 27(f)(b).
excluded or exempted from the Act. In other words, Congress permitted the casinos to decide if they wanted to be subject to law or be a law unto themselves! In light of the systemic risk that materialized in the 2008 crisis, it is ironic that Congress justified the legal free ride granted in 2000 by claiming its purpose was to "reduce systemic risk."

One additional subtle change was made to the CEA by the CFMA, which appears to have gone unnoticed by commentators. Congress removed the requirement to review contracts admitted to an exchange for compliance with the public interest. As noted earlier, CFTC regulations interpreting this standard required that the contract have some economic purpose other than mere speculation. In the case of the newly created Derivative Clearing Organizations, the CFMA did not include the "public interest" review of new products submitted for clearing, but merely required such organizations to adopt "appropriate standards for determining eligibility of agreements, contracts, or transactions submitted" to the clearing organization. In lieu of the prior regulation, which interpreted public interest to require an economic interest other than speculation, the CFTC adopted regulations interpreting the vague "appropriate standards" requirement for new product eligibility that merely refers to the Derivative Clearing Organization's ability to manage risks associated with a product. With respect to Contract Markets, this vague "appropriate standard" review of new products is not even included in the eligibility requirements for designation of Boards of Trade. There is merely a requirement that the "board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation."

308. See Edwards et al., supra note 301, at 16; see also Johnson & Hazen, supra note 302, at 40 (noting that the CFMA "places far more reliance than ever before on the ability of large institutions and wealthy individuals voluntarily to engage responsibly in futures activity" (emphasis added)).

309. Commodities Futures Modernization Act of 2000 § 2(6).

310. Despite extensive searches, I have found no contemporaneous or subsequent commentary on this specific change. For example, the Committee on Agriculture's report on the CFMA merely states that the act "strikes current law" (the former section addressing designation of Boards of Trade as Contract Markets) and "adds a new section." H.R. Rep. No. 106-711, pt. 1, at 36 (2000). With respect to the former section which contained the "public interest" language, the report merely states that "Subsection (b) contains criteria that boards of trade must meet in order to be designated as a contract market" without noting the deletion of the public interest requirement. Id.

311. Commodities Futures Modernization Act of 2000 § 1(a); see also supra text accompanying note 262.

312. See supra text accompanying note 263.


concern for speculation is replaced merely by concern for settlement risk and market manipulation. Although a subtle change, I believe this change symbolizes the complete rejection in 2000 of the millennia-old policy against speculation. Although some regulation was restored in 2010, it only focuses on providing for an orderly market and not on preventing gambling. This subtle deletion in the CEA of a public policy against new products facilitating speculation symbolizes the general change of policy in federal law. This policy change can be detected by comparing the “Legislative Findings” section of the CEA before and after the adoption of the CFMA. Formerly this section stated:

Transactions in commodities involving the sale thereof for future delivery as commonly conducted on boards of trade and known as “futures” are affected with a national public interest. . . . Such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodities and the products and byproducts thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price. The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed . . . rendering regulation imperative for the protection of such commerce and the national public interest therein.\(^{316}\)

The CEA formerly acknowledged that futures contracts could be used by those “engaged in handling commodities . . . as a means of hedging themselves against possible loss,” but could also give rise to “excessive speculation,” which needed to be regulated in light of the public interest. The CFMA deleted this section and replaced it with a different conception of the public interest:

(a) The transactions subject to this chapter are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities.

(b) Purpose. It is the purpose of this chapter to serve the public interests described in subsection (a) of this section through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission. To foster these public interests, it is further the

purpose of this chapter to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants.\footnote{317}

The reference to "excessive speculation" has been deleted and the focus has shifted to self-regulation of trading platforms and the prevention of market and price manipulation. As with the elimination of the contract review for the public interest, the Agriculture Committee report merely notes that the new language "[r]ewrites section 3 of the CEA" without any further comment on the substance of that rewrite or the policy implications of it.\footnote{318}

Although the current CEA does still contain a provision referring to the market-distorting effects of "excessive speculation," the CEA merely permits the CFTC to limit positions taken in particular commodities so as to limit the extent of speculation on a particular product.\footnote{319} Whereas the law formerly saw gambling, including gambling on financial markets, as being wrong \textit{per se}, the new federal orientation suggests that such gambling is not a problem \textit{per se}, but merely a potential for manipulation or price distortion, which only needs to be somewhat constrained. This policy assumption continued to undergird the re-regulation that occurred after the financial crisis.

In the wake of the 2008 financial crisis, Congress did subject swaps to some federal regulation, but in so doing, reaffirmed the quarantine of state anti-gambling law, reworded to take account of the new jurisdictional split between the Securities Act and the CEA.\footnote{320} Although following the financial crisis, some lawmakers suggested using federal law to completely prohibit credit default swaps,\footnote{321} such attempts went no further than the introduction of a bill, despite vocal support for a prohibition of at least naked credit default swaps.\footnote{322} In the wake of the New York Insurance Department's announcement to begin regulating some CDSs as insurance,\footnote{323} Dodd-Frank

\footnote{317. Id. (as amended by Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-383). The Dodd-Frank Act did not change this section.}

\footnote{318. See H.R. REP. No. 106-711, pt. 1, at 36 (2000).}

\footnote{319. 7 U.S.C. § 6a (2012).}


\footnote{321. See sources cited \textit{supra} note 7.}

\footnote{322. See Bloink, \textit{supra} note 8, at 605.}

\footnote{323. See \textit{supra} text accompanying notes 284–86.}
actually expanded federal preemption of potential state law regulation by directing that state insurance regulators could not regulate any swap. Although Dodd-Frank ended the virtually complete federal, legal, and regulatory pass for CDSs, it only regulates the sale, distribution, and clearing of certain swaps. It also introduces some regulation of swap dealers, but it does not regulate the use of CDSs (i.e., it does not prohibit or regulate speculative uses of CDS contracts) as state law formerly did.

With state gambling law still quarantined, Dodd-Frank did initiate some regulation of swap transactions. The new world of federal regulation is a highly complex and balkanized system splitting jurisdiction between the SEC and the CFTC. Dodd-Frank divides the genus of swaps into three regulatory species: “swaps,” “security-based swaps,” and “mixed swaps.” It then generally grants the securities laws and the SEC with jurisdiction over security-based swaps and the CEA and CFTC with jurisdiction over other swaps. The SEC and CFTC share authority over mixed swaps. For CDSs, this means if the Reference Obligation is a security (under federal securities laws) then the CDS would be a security-based swap subject to applicable provisions of the Securities Act and the Exchange Act. Such CDS contracts would have to be registered under the Securities Act or exempted from registration. Given that CDS contracts have not been sold to the public generally, it seems unlikely that the registration and subsequent disclosure requirements impact CDS transactions. Dodd-Frank adopted the former


325. See Bloink, supra note 8, at 605-07. Specifically, the act: (1) grants the SEC regulatory authority over CDSs; (2) requires clearing of CDSs; (3) requires registration of “swap dealers” and “major swap participants”; and (4) claims to restrict a future government bailout of “swaps entities.” Id. Obviously, a future Congress could simply amend the provision and bail out a failing institution.


328. Molony, supra note 326, at 990. A swap agreement that does not meet the definition of a security-based swap but whose value is still connected to a security is considered a “security-based swap agreement,” which is included within the CEA’s definition of swap and thus subject to primary regulation by the CFTC and only anti-fraud regulation under security laws. See id. at 990–91.

329. See Bloink, supra note 8, at 607.

330. See Molony, supra note 326, at 988–90. Such a CDS would also be subject to the information-reporting obligations (if listed on a securities exchange or held by a requisite number of holders) and antifraud provisions of the securities laws. See id.
approach of the CEA with respect to futures contracts, requiring that security-based swap agreements be cleared through centralized clearing organizations.\textsuperscript{331} Like the current version of the CEA, the SEC’s review of the clearing organizations does not include a required review for the swap’s consistency with the public interest, nor does it require any demonstration of a purpose besides speculation. Instead, the requirements merely focus on the effect of a swap contract on an orderly market and the clearing agency’s ability to settle trades.\textsuperscript{332} Dodd-Frank excluded many security-based swap transactions from the mandatory clearing requirement and vested the SEC with discretion to grant other exclusions.\textsuperscript{333}

The CEA requires that a CDS that does not reference a security (or otherwise does not fall within the definition of a security-based swap) be executed through an exchange or cleared through a clearing organization.\textsuperscript{334} Yet, as with security-based swaps, Dodd-Frank exempts many transactions and permits the CFTC to exempt other derivative transactions from the exchange or clearing requirement.\textsuperscript{335} As noted earlier, Dodd-Frank left in place the weaker standard for review of new swap products and avoided language discouraging products with no purpose other than speculation.

Trading off-exchange is prohibited unless the off-exchange contract is for hedging purposes.\textsuperscript{336} Forced clearing through exchanges or clearing organizations does put some limits on speculation, since the exchanges guarantee trade performance and set margin and capital requirements.\textsuperscript{337} Rather than prohibiting gambling (or even simply refusing to enforce gambling contracts), forcing speculative derivatives onto exchanges is the equivalent of forcing gambling into licensed casinos.

It is also unclear how many CDSs must be centrally cleared. Given the exemptions and the scope of the CFTC and SEC to grant more exemptions, the amount of CDSs that will remain in the OTC, privately settled, the market is uncertain. The most significant exemptions are for (1) cases when a centralized market for the swap is unavailable\textsuperscript{338} and (2) non-standard swaps

\begin{thebibliography}{9}
\bibitem{333} 15 U.S.C. § 78c-3(g).
\bibitem{334} See 7 U.S.C. §§ 2, 7a; see also Stout, supra note 3, at 35–36.
\bibitem{335} Stout, supra note 3, at 35–36.
\bibitem{336} Id. at 34.
\bibitem{337} Id.
\end{thebibliography}
transacted between swap dealers or major swap participants (terms defined in Dodd-Frank). Since the “common thread” running through the story of the collapse of AIG, the monoline insurance industry (MBIA and AMBAC), Lehman Brothers, Bear Stearns, and government agencies, including Fannie Mae and Freddie Mac, was the use of “non-standardized, highly illiquid security-based swaps,” it would seem that many of the derivatives at the heart of the collapse of these entities would have been exempt from the new clearing requirement. “An increasingly large percentage” of such derivative contracts have been bespoke products and highly customized, which suggests that many will not be required to be cleared. According to a 2010 Bank of International Settlements (“BIS”) study, approximately 89% of then currently outstanding CDSs (by notional amount) were non-standardized and would not be able to be cleared centrally. The 11% of CDS contracts which were standardized represented only 4% of all CDSs by market value.

In general, current federal regulation requires that some small portion of CDSs might be required to trade and settle through an exchange or clearinghouse subject to the CEA or the security laws. Forcing transactions onto exchanges or clearinghouses might bring some restraint on gambling to that limited percentage of derivatives through position and margin limits applied to some traders and might place some limitations on short selling under the securities laws. However, as Professor Stout has observed: “[i]n practice, it is unclear how effective margin requirements and shorts sales restrictions are in discouraging stock speculation.” Such restraints would not apply to the exempt derivatives. Exempt transactions, although not required to be cleared, must still be reported to a swap repository, thus providing some transparency for even the privately-settled swaps. Some


339. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 721 (codified at 7 U.S.C. § 1a) (defining a “swap dealer” and “major swap participant”).


341. Id. at 709.

342. See Johnson, supra note 12, at 240.


344. Id.

345. See Stout, supra note 10, at 775.

346. See id. at 730–31.

347. Id. at 731.

commentators hope that the clearing requirement (and related reporting) will bring “market-wide transparency and address counterparty and other credit risks.” Although regulators are authorized to set capital and margin requirements for OTC counterparties, they are granted wide discretion in setting any requirements, which could be interpreted to permit regulators to set margin requirements at zero. Although such rules may help with ensuring counterparty performances of OTC derivative contracts, none of the federal regulation of either cleared or OTC CDSs regulates their use, as state law formerly did. None of the new regulations contain rules to prevent a new bubble of ballooning wagers through CDSs, as occurred before the 2008 financial crisis.

IV. CONCLUSION

I have argued elsewhere that the art of making human law is best practiced through a dialectical interaction of general moral principles of the natural law, historically developing legal customs through case by case determinations and targeted statutory enactments. When this complex, inductive/deductive process is replaced by a comprehensive statutory regulatory regime, I have argued that the results include an ever-expanding verbosity of law that is in constant need of amendment, coupled with a growing disrespect for law.

Once an omnibus statute is enacted, centuries-old principles can be eliminated by the stroke of a legislative pen, without comment or fanfare. The legal story of financial speculation and CDSs related in this article constitutes a compelling case study for these conclusions. For centuries, the general moral condemnation of wagering on price movements was preserved, interpreted and applied by common law courts to draw appropriate distinctions among insurance contracts, indemnity agreements and wagering. State legislatures intervened in the development to enact specific statutes that responded to new venues for harmful wagering, such as bucket shops, and expanded the common law remedy, from a refusal to enforce wagering contracts, to making such contracts illegal and criminal. The federal government interfered in this centuries-old, ongoing development, first by the Supreme Court exempting exchange traded futures contracts from the

349. Johnson, supra note 12, at 234.
351. Id.
352. See McCall, supra note 9.
353. Id. at 43.
common law prohibition on wagers, and eventually by Congress’ complete preemption of all state law applicable to gambling and, after Dodd-Frank, even insurance products. When a new commercial contract appeared, the credit default swap, state law was forced to sit by and watch the market for such contracts explode in monumental proportions, while the federal government worked to confirm and secure a complete legal bypass for what Warren Buffett called “weapons of financial mass destruction.”

Due to the federal preemption, the former dialectical system was never applied to CDSs. If allowed to function as it formerly had, legal and philosophical history indicates that state law would have developed a nuanced set of principles to control the use of CDSs based on the same principles underlying insurable interest, indemnity and intent to deliver doctrines. Those contracts that were used to transact a policy of insurance on a financial asset would have been regulated by insurance law and subject to prudential and safety and soundness regulations. Those contracts, which, although not insurance, were nonetheless used to shift risks of loss connected to financial assets held by the Protection Buyer, would likely have been found acceptable by state courts. Those CDSs in which the Protection Buyer owns no asset for which the credit default swap provides proportionate protection and in which no party had any intention to actually deliver the underlying security would have been held unenforceable as wagering contracts under the common law and the contracting parties perhaps subjected to statutory penalties. Those choosing to engage in such wagers would have to do so subject to the legal risk of unenforceability and possible criminal sanctions in states which have enacted anti-bucket shop statutes. Even financial magnate George Soros recommended as much when he argued that: “CDS[s] ought to be available to buyers only to the extent that they have a legitimate insurable interest.”

Yet, this alternative, safer proposal of Mr. Soros has never been adopted and is not likely to be adopted in the foreseeable future since the Dodd-Frank Act preserved in fact the quarantine of virtually all state law. Although the reform act may bring some order to the market for derivatives and some transparency, it firmly reinforces the federal policy to abandon the millennia-old philosophical and legal disapproval of speculative wagering. Dodd-Frank, combined with other applicable federal statutory regimes such as the CEA, the Securities Act and the Exchange Act, offers thousands of pages of statutory language, which has the deleterious effect of eviscerating the

354. Buffett, supra note 2, at 15.
355. Soros, supra note 125.
ancient public policy against wagering. “The Dodd-Frank Act has been subject to widespread criticism for its length and complexity,” which is exactly what I predicted would be the results of making human law primarily by comprehensive statutory fiat. Although, due to the new clearing requirement, we might have some more public information about who is gambling and how much is involved, and while there might be a lower systemic risk of counterparty failure to settle the bets, it is certain that the legal system still permits the type of gambling that exploded in 2008. Those willing to place our financial future on the roulette board are free to do so as long as they clear it in a legal casino (clearing house or exchange) or persuade the SEC or CFTC to let them gamble off-casino. This analysis suggests that, despite Dodd-Frank, we remain subject to future financial crisis driven or sustained by gambling induced bubbles. The long-term solution is to repeal federal preemption of state law so that it can supplement the federal infrastructure of organized markets and clearing for beneficial CDSs by restraining harmful financial wagering. State law still contains all the philosophical and legal concepts and principles to do the weeding, if federal law would untie state judges’ and legislators’ hands. Certainly difficult questions will need to be resolved in order properly to draw the line between legitimate uses of CDSs and gambling. Complex jurisdictional issues among the states, the federal government and offshore jurisdictions would certainly arise. Rather than simply giving a license to gamble, the federal government should work with state law to resolve these questions and restrain financial gambling. Can our economy and our country afford to bail us out of another big loss the next time the economy draws a losing card, as was done in 2008? It does not seem worth the risk to wait to find out.

356. Stout, supra note 3, at 33.
357. McCall, supra note 9, at 37.