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Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention.  
A Model for the Future of U.S. Regulation?

This comment will focus on the developments in the credit derivatives market in 2005-2006, focusing specifically on the private sector initiative that addressed problems that had developed in this evolving market during its tremendous growth in recent years. The success of this initiative was a significant accomplishment, not just for the quick and efficient progress made, but because the market was able to self-correct its industry-wide problems, thereby avoiding the need for regulatory intervention by an outside regulatory entity.

This initiative will then be discussed in the context of recent concern over the competitiveness of U.S. markets, due to perceived regulatory inefficiency and hindrance, as a model for a proposed regulatory framework that shifts more authority to markets to self-regulate under the oversight of a consolidated single governmental regulator for all financial markets.

Part I will briefly introduce financial derivatives, and attempt to give the reader a sense of their growing importance in the financial world. Part II will examine the current state of regulation (or lack thereof) in the derivatives markets. Part III will then explore the credit derivatives market in more detail, orienting the reader as to the role of credit derivatives and discussing some basic types and variations of these instruments. Part IV will discuss in detail the recent developments in the credit derivatives markets and the industry initiative that was able to self-correct the major problems facing that market.

Part V will look at some of the recent concerns for the waning of U.S. competitiveness in the global financial markets, focusing on the perceived deficiencies in the current regulatory structure. Finally, Part VI will propose a model for a new regulatory framework derived from the model applied in the credit derivatives market, where the market participants were allowed to
address the problems within the market through collaborative effort. This market participant initiative approach will then be discussed as part of a regulatory structure where substantial rulemaking authority will be shifted to similar initiatives that are guided by a single governmental regulator that oversees all financial markets.

**PART I: Derivatives, In General**

In the financial context, derivatives are instruments whose value is measured by reference to an underlying contract or asset. They “derive” their value from the value of an external thing. Another way to look at derivatives is as a form of price guarantee: an agreement between a future buyer and a future seller at some designated point in time. “They allow investors to place bets on the direction of markets, without ever needing actually to own tangible assets in that market.” Because of the increasing complexity of variations and innovations in the types and arrangement of derivatives contracts, any more generalized definition is not possible.

Derivatives are not a current invention, but they are becoming increasingly important in the way that the financial world operates. Derivatives are employed as a way to hedge other positions, to speculate, and as a means of arbitrage. Their versatility is one of their most

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1 This comment assumes some knowledge of derivative financial instruments, and therefore some of the terminology in that market will not be defined. For a comprehensive introduction to derivatives, see Michael Durbin, All About Derivatives (2006).

2 “A derivative transaction is a contract . . . whose value depends on (or ‘derives’ from) the value of an underlying asset, reference rate, or index.” Group of Thirty, Derivatives: Practices and Principles 2 (July 1993).

3 “Underlyings can be anything that interests markets: cash instruments, like stocks and bonds; tangibles, like commodities; or intangibles, like interest rates, currency rates, stock market indices and credit quality.” Norman Menachem Feder, Deconstructing Over-The-Counter Derivatives, 2002 Colum. Bus. L. Rev. 677, 681 (2002).

4 A User’s Guide to Derivatives, Fin. Times (London), Nov. 18, 2006, at 19 (giving a quick snapshot of the various derivatives markets, including interest rate derivatives, foreign exchange derivatives, credit derivatives, equity derivatives, and commodity derivatives).


intriguing and important characteristics.\textsuperscript{7}

Arbitrage is the strategy of searching for mistakes or discrepancies in pricing across markets and then exploiting those discrepancies by simultaneously buying at one price and selling at another, and profiting from the spread.

Hedging is the practice of taking an offsetting position in one investment to counteract the risk that has been taken in another investment position. This is one of the most significant functions of derivatives: their usefulness and efficiency in allowing parties to allocate risk. Hedging allows a party to take on a “risky” investment opportunity and then re-allocate some or all of that risk to another party, thereby giving up some of the potential return on the initial investment, but at the same time limiting the risk that the initial investment will pose.\textsuperscript{8}

Derivatives allow a speculator to take a position based on how he thinks a market will move, but without having to purchase outright the instruments or assets that make up that market.\textsuperscript{9} Speculating and hedging with derivatives both employ the power of leverage, allowing

\textsuperscript{7} It should be noted that not all financial professionals embrace derivatives. See e.g., Letter from Warren Buffet, Chairman, Berkshire Hathaway, Inc., to Shareholders, at 15 (Feb. 2, 2003) (referring to derivatives as “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal”). But see, recently, Letter from Warren Buffet, Chairman, Berkshire Hathaway, Inc., to Shareholders, at 17 (Feb. 28, 2003):

I should mention that all of the direct currency profits we have realized have come from forward contracts, which are derivatives, and that we have entered into other types of derivatives contracts as well. . . Why, you may wonder, are we fooling around with such potentially toxic material? The answer is that derivatives, just like stocks and bonds, are sometimes wildly mispriced. For many years, accordingly, we have selectively written derivative contracts – few in number but sometimes for large dollar amounts. We currently have 62 contracts outstanding. I manage them personally, and they are free of counterparty credit risk. So far, these derivative contracts have worked out well for us, producing pre-tax profits in the hundreds of millions of dollars (above and beyond the gains I’ve itemized from forward foreign-exchange contracts). Though we will experience losses from time to time, we are likely to continue to earn – overall – significant profits from mispriced derivatives.

\textsuperscript{8} It is important to remember that derivatives do not eliminate the risk of the initial investment, they just reposition it, \textit{i.e.} lay it off onto another party, allowing the risk to be spread out and reducing each party’s exposure to a level that they are comfortable undertaking. See Feder, supra note 2, at 683 (stating that “derivatives do not eliminate risk; they only reposition it.”)

\textsuperscript{9} For example, if an investor believed that stock of company XYZ was going to go up in value over the next year, he could either (1) buy the stock and hold it for a year until it appreciated in value; or (2) enter into a forward contract for that stock, whereby he agrees to buy some amount of the stock in one year at some designated price (presumably less than he thinks it is going be at that time); or (3) if that stock is traded on a futures exchange, enter into a futures contract for that stock (the primary differences between a futures contract and a forward contract is that the futures
a party to take positions that “focus ‘financial energy’ so hedgers and speculators can get more work done with less effort,” i.e. make more efficient use their money by tying up less money in each position.

*Derivatives Markets*¹¹

Derivatives can be divided into two broad categories: exchange traded and over-the-counter (OTC). The exchange-traded market tends to have more standardized contracts, and takes place on a central platform where parties act through an intermediary, called a market-maker. The parties do not interact with each other, but rather enter into pre-established contracts with the market-maker who acts as the counterparty both to the buyer and the seller. The exchange traded market primarily consists of two groups: futures¹² and options.¹³

The OTC market for derivatives consists of parties entering into contracts directly with each other, where they have the ability to formulate transactions that are exactly tailored to their respective needs. This allows for much more innovation and variation since the parties can negotiate the specific details of the deal directly with each other. The OTC market consists of many variations on these types of basic derivative contracts: forwards, options, and swaps.

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¹⁰ DURBIN, supra note 1, at 5.
¹¹ In this section, estimates for the notional amounts outstanding in the exchange traded and over-the-counter markets are given. However, it should be noted that estimating notional amounts of the markets overstates the risk exposure of the markets since parties hedge positions by taking offsetting positions in other transactions, thereby increasing the notional value of the market, but reducing the market’s true exposure to risk.
¹² The latest report from the Bank for International Settlements (BIS) estimates that the total global outstanding notional principal amount of exchange traded futures is almost $26 trillion. BANK FOR INT’L SET., SEMIANNUAL OVER-THE-COUNTER (OTC) DERIVATIVES MARKETS STATISTICS app. at 108 (2006Q2) (Table 23A: Derivative financial instruments traded on organised exchanges).
¹³ The BIS estimates the total global outstanding notional principal amount of exchange traded options is almost $50 trillion. Id.
¹⁴ The BIS estimates the total OTC notional amounts outstanding as almost $370 trillion. Id. at app. 103 (Table 19: Amounts outstanding of over-the-counter (OTC) derivatives).
PART II: Regulation of Derivatives

The present state of derivatives regulation is governed primarily by the Commodity Futures Modernization Act of 2000 (CFMA), which amended the Commodity Exchange Act (CEA). The CEA was enacted in the mid 1930s, contemporaneous with the laws governing securities regulation. Regulation of futures was separate from the securities laws because of the strong agricultural influence in Congress. The primary use of futures in the nineteenth and early twentieth centuries was to ensure stable crop prices by allowing farmers and dealers to enter into pricing contracts that were not subject to the high degree of seasonal volatility that had plagued the agricultural markets. The CEA did not envision the over-the-counter markets for derivatives; in fact, it required all futures contracts to be traded on a “contract market,” such as the Chicago Board of Trade.

In 1974, Congress amended the CEA with the Commodity Futures Trading Commission Act (CFTCA), creating a regulatory oversight commission for the futures markets that was similar to the Securities Exchange Commission (SEC). Although the CFTC and SEC struggled

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19 Prices would skyrocket during the off-season, when the supply of crops was low, but then those prices would plummet after the crops were harvested when the market was flooded with that year’s supply. See William Cronon, Nature’s Metropolis: Chicago and the Great West 123-25 (1991). Forwards and futures developed to stabilize these prices for commodities like crops. See Chicago Board of Trade, Commodity Trading Manual 3-4 (1982).
20 In fact, the enforceability of OTC derivative transactions and swaps was not even certain until the Futures Trading Practices Act of 1992, which amended the CEA. Pub. L. No. 102-546, 106 Stat. 3590. In the FTPA, Congress provided that transactions by certain “appropriate persons” (e.g. institutional traders) could be exempt from the exchange trading requirement of the CEA. For a discussion of the exemptive provisions of the FTPA, see Markham, supra note 6, at 22.
over jurisdiction, especially concerning “hybrid” instruments,23 it was the CFTC that made the move to create a more harmonized regulatory framework for derivative instruments.24 The regulations proposed by the CFTC became the basis for the regulatory framework in the CFMA. Thereafter, the CFTC then adopted a revised set of regulations to implement the CFMA.25

The CFMA26

Congress enacted the CFMA, inter alia, with these purposes in mind:

(6) to promote innovation for futures and derivatives and to reduce systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions;
(7) to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations; and
(8) to enhance the competitive position of United States financial institutions and financial markets.27

With those guiding purposes in mind, they sought to create a regulatory framework that would allow the innovation of derivative instruments to flourish and not be stifled by excessive regulation that was unnecessary for the sophisticated parties participating in those transactions.

The three themes of flexibility, legal certainty and shared regulatory coordination run

23 Hybrid instruments contained elements of futures, options and securities, thus sparking jurisdictional confusion as to who should be able to regulate this market: the SEC or CFTC. For a discussion of these jurisdictional problems, see Jerry W. Markham, Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives, 1990 Colum. Bus. L. Rev. 1 (1990). Further compounding the problem of CFTC regulatory jurisdiction was the Treasury Amendment to the CEA, which stated that the CEA did not governs or apply to an agreement, contract, or transaction in foreign currency; security warrants, security rights, re-sales of installment loan contracts, re-purchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sales thereof for future delivery conducted on an organized exchange. 7 U.S.C. §2(c) (2006). For a discussion of the jurisdictional and interpretative difficulties surrounding the Treasury amendment, see Markham, supra note 6, at 18-21.
24 The CFTC proposed regulations that were the prelude to the regulatory framework that Congress adopted in the CFMA, which included exempting swap transactions and creating a tiered regulatory framework. See 65 Fed. Reg. 77962 (Dec. 13, 2000); see also Jerry W. Markham, 13A Commodities Reg. § 27:12:1.
26 The 2000 CFMA established a set of “core principles that contract markets would have to abide, meant to open up competition by eliminating prescriptive rules. CFTC Reauthorization to Dominate 2005; Security Futures, Energy Likely Topics, 37 Sec. Reg. & L. Rep. (BNA) [No. 2, at 72] (Jan. 10, 2005). Other highlights of the act were the establishment of security futures products and a unique regulatory structure to oversee them, the assurance of legal certainty for derivatives products and a sliding scale of oversight for contract markets that depended on the level of sophistication of participants. Id.
27 Purposes of CFMA, supra note 22, at section 2.
throughout the CFMA. The CFMA had two important consequences for derivatives markets: first, it clarified that certain OTC derivative transactions were outside the jurisdiction of the CFTC, and it allowed the trading of single-stock futures and futures on narrowly-based stock indices (under joint jurisdiction of the SEC and CFTC).

The CFMA excludes OTC derivative transactions from regulation as long as the parties are Eligible Contract Participants that are negotiating bilateral contracts for excluded or exempt commodities. The CFMA also provides legal certainty for swap agreements, and specifically states that nothing in the CEA shall apply to “certain swap agreements (including credit and equity swaps), hybrid instruments and other products commonly offered by banks.” Also, the CFMA provides that futures on single stocks and narrowly based indices are now allowed under joint jurisdiction of the SEC and CFTC. The CFTC remained as the sole regulator of commodity exchanges, having a monopoly over markets in which small traders were allowed to participate in futures and options.

The effect of these provisions was to provide certainty to OTC derivative transactions and remove them from any regulatory interference as long as “eligible” parties to such contracts

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30 Eligible Contract Participants broadly means that the party must be a large sophisticated institution or a wealthy individual. For a detailed explanation of Eligible Contract Participant, see CFMA, supra note 22, section 101. Definitions. Excluded commodities are interest rates, exchange rates, currencies, securities, securities indices, credit risks and measures such as inflation and other indices based solely on commodities that have no cash market or on prices or values not within the control of any party to the transaction. Exempt commodities are all commodities that are not “excluded” and not agricultural commodities, such as metals and energy products. See Markham, supra note 23.
31 See CFMA, supra note 22, at Title III.
32 Kloner, supra note 29, at 287.
34 Jerry W. Markham, 13A Commodities Reg. § 28:3.
abided by the rules in the CFMA. “Market share gradually slipped away to the over-the-counter derivatives markets” because the lack of regulation allowed the OTC market to develop quickly through innovation while the exchange traded market was stifled by persistent adherence to custom and remained rooted in traditional derivative instruments.  

There has been tremendous freedom given to the OTC derivative markets, as one report has noted:

> It is commonly said that the market in over-the-counter derivatives is unregulated. Compared to the exchange-period derivative market, this is true. The futures and options exchanges operate under the scrutiny of a regulatory agency -- the CFTC and the SEC -- with broad authority to monitor transactions, to require registration and financial disclosure of market position, to establish and enforce rules of conduct and financial standards, and to intervene directly in the marketplace, if need be, to maintain fair and orderly trading. There is no such overarching regulatory structure in the over-the-counter market.  

This freedom has allowed the OTC derivative market to evolve without strictures. New instruments and products are freely developed to accommodate the varied needs of parties seeking to reduce their exposure to risk, as well as to make the most efficient use of their resources through the leverage employed by derivative instruments.

One corner of the OTC derivative market has been growing at an astounding rate, and while there have been some bumps in the road, the industry has come together under the watchful eye of regulators to make tremendous strides in solving the problems that such growth

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35 *Id.* The Chicago Board of Trade and the Chicago Mercantile Exchange were once the predominant exchanges for futures, but the Eurex exchange and even newer exchanges like the Intercontinental Exchange (ICE) were able to undercut the American markets by adopting electronic trading while the CBOT and CME remained steadfastly tied to the trading floors. “Like the American car manufacturers in the 1970s, the exchanges and their members saw their volume being eroded by more nimble competitors, but refused to compete, preferring shelter in their dwindling market share to the risks of competition.” *Id.*


37 It is important to note that the OTC derivatives market is not *un-regulated*, but rather “[o]ne of the major reasons behind the exclusion of OTC derivatives from [the CFTC’s] jurisdiction was the fact that other Federal regulators were already overseeing many of the entities trading these products.” Lukken, *supra* note 28. The sophisticated institutions that deal in OTC derivatives are large banks and firms that are regulated by the Federal Reserve Bank, the SEC and other regulatory agencies; it is only the OTC derivative transactions themselves do not have a separate regulatory agency.
PART III: Credit Derivatives

The credit derivatives market has grown exponentially over the last five years. It has been called “the fastest growing financial market there is.” According to the British Bankers’ Association Credit Derivatives Report 2006, the notional amount outstanding for credit derivatives was less than $1.2 trillion at the end of 2001, and they estimated that the market will reach over $20 trillion by the end of 2006, and over $33 trillion by 2008. This estimate seems conservative compared to the ISDA 2006 mid-year report which estimated that the notional amount of credit derivatives was $26 trillion, a 109% increase from mid-2005. These statistics clearly indicate the phenomenal growth of the credit derivatives market and its increasing importance in the financial world.

One may think of credit derivatives as a form of performance guarantee. Credit derivatives, unsurprisingly, deal with the allocation of credit risk. Credit risk is the risk a party faces that his counterparty will default on their obligation to him. Credit derivatives allow a party to “unbundle” credit risk from the other risks that an investment carries. Credit derivatives are intended to reduce risk by spreading that risk out among many parties. The credit protection buyer buys protection from the protection seller to mitigate, or even eliminate,
the risk that a reference entity will default on its obligation to the buyer.\textsuperscript{45} The protection buyer and seller are free to determine what will constitute a “credit event” so as to trigger the obligation of the protection seller to compensate the protection buyer.\textsuperscript{46}

Credit derivatives are primarily used to:

- Reduce risk from ownership of bonds or loans;
- Take exposure to an entity, as one would do buying a bond or loan;
- Express a positive or negative credit view on a single entity or a group of entities, independent of any other exposures to the entity one might have.\textsuperscript{47}

The idea of reallocating credit risk, or the risk of default, is not new; banks have done it for years when they syndicated loans or took third-party guarantees and letters of credit. The novel aspect of credit derivatives is that it allows for a market in credit risk that is completely separated from the underlying reference obligation, allowing the market to trade the credit risk separately from the instrument that creates the risk.\textsuperscript{48} This allows for much more than just “default protection;” a speculator, confident that the reference entity will not default, can collect the premium as a protection seller, and an arbitrageur or market-maker can find discrepancies in the markets and exploit them by selling credit protection to one party and then buying that same protection from another party at a lower price, or buying low and selling high, and pocketing the difference.\textsuperscript{49}

\textit{Types of Credit Derivatives}

\textsuperscript{45} As Durbin points out, this begs the question of how you can be sure that the protection seller will not default. Thus in reality you have just substituted one credit risk for another. Durbin, supra note 1, at 63 n.1.

\textsuperscript{46} While the parties are free to determine what will constitute a credit event for their transaction, there are five standard credit events defined by the ISDA: bankruptcy, failure to pay, obligation default, obligation acceleration and restructuring. “Bankruptcy involves seeking court protection from creditors when a company can’t pay its bills, failure to pay is essentially like missing a payment on a car loan, obligation default is when the lender declares the borrower in violation of payment terms and demands return of the principal, obligation acceleration is when the terms of a debt call for immediate payment of some or all of a debt “ahead of schedule” as a result of some issue, and restructuring is a broad event that includes things like debt consolidation.” Id. at 65.

\textsuperscript{47} CRMPG II Report, infra note 83, at app. A-3.

\textsuperscript{48} Feder, supra note 2, at 707.

\textsuperscript{49} Durbin, supra note 1, at 62-63.
There are many different types of credit derivatives, and this comment will only outline a sample to convey the variety of instruments and their uses. First, four of the basic credit derivatives will be discussed; including credit default swaps, total return swaps, credit linked notes and collateralized debt obligations. Then, this author will briefly sketch of a few more complex and innovative products being employed in the market today to orient the reader to the intricate nature of this market in practice.

The most prevalent and simplest type of credit derivative is the credit default swap (CDS). A CDS is like a homeowner’s policy – where the protection buyer pays a premium (called a CDS spread) to the protection seller, whereby the seller will compensate the buyer for any loss resulting from a “credit event” incurred by the reference entity. The primary buyers of single-name CDSs are commercial lenders and corporate or sovereign bond holders, and the primary sellers are insurance companies and large financial institutions.

A CDS can reference a single debt security (e.g. a bond) from a single reference entity, called a single-name CDS, or it can reference a portfolio of different debt securities from different reference entities, this is called a portfolio CDS. Variations on the CDS include the “first or n\textsuperscript{th} to default,” the “CDS option,” an index-linked CDS, and a “binary CDS.”

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50 “The diversity of the range of credit derivatives products continues to expand and since the first BBA survey was published in 1996, the market has risen exponentially.” Press Release, British Bankers’ Ass’n, Credit Derivatives expected to reach $33 trillion by end of 2008 (Sept. 21, 2006) (quoting Ian Mullen, Chief Executive of the BBA).

51 Some authorities estimate that credit default swaps make up 95% of the credit derivatives market. Credit Derivatives Market Swells to $26 Trillion in Year, Association Says, 38 Sec. Reg. & L. Rep. (BNA) [No. 38, at 1590] (Sept. 25, 2006).

52 See supra note 46 for an explanation of common credit events.

53 See supra note 1 at 64.

54 The “first or n\textsuperscript{th} to default CDS” is a form of portfolio CDS where the protection seller pays the protection buyer when the “first” or “n\textsuperscript{th}” (depending on the terms of the contract) reference entity in the portfolio experiences a credit event. This type of CDS is cheaper than buying a single-name CDSs on each reference entity. See Donald A. Bendernagel, Common Derivatives and Their Uses: Credit Derivatives, 1559 PLI/Corp. 85, 98-101 (September 14, 2006).

55 In exchange for a premium, the “CDS option or Credit Default Swaption” creates the right to buy or sell a CDS on a reference entity ion the future at a predetermined price. The buyer would enter into a CDS option if it believes that the cost of a CDS on a reference entity will increase, thereby enabling the buyer to buy protection at a lower price.
Another type of credit derivative is the total return swap. This allows a protection buyer to “rent out” an asset. The protection seller pays a stream of regular, usually fixed, payments in exchange for the protection buyer transferring all income and capital changes from the reference asset to the protection seller. The protection seller takes all losses and gains incurred by the asset, but the asset remains on the protection buyer’s balance sheet. The main difference between the total return swap and a CDS is that the protection seller makes payments regardless of the performance of the reference asset, rather than compensating the protection buyer for the occurrence of a credit event by the reference entity.\(^58\)

Another form of credit derivative is the credit linked note. In this financial vehicle, the protection seller raises capital from investors for the express purpose of issuing credit protection to protection buyers. That capital is held for the sole purpose of providing compensation to credit buyers in the event of a credit event by a reference entity. A “special purpose vehicle” (SPV) or “special purpose entity” is often created to act as the protection seller. The buyer still pays a premium to the seller, but the seller then pays part of that premium to the investors for use of their money. A credit linked note removes the credit risk of the credit protection buyer \(\text{vis a vis}\) the seller, because the money is being held for the sole purpose of providing credit protection, thus theoretically eliminating the risk of default by the seller.\(^59\)

\(^{58}\) An index linked CDS is an extremely liquid instrument that is like buying a CDS on each reference entity that composes the index all at once. An example is the Dow Jones CDX.IG, which is composed of 125 reference entities. The instrument is so liquid because of the diversity of the entities that compose the index, which enables the index-linked CDS to be an effective hedge for many positions. See id. at 112.

\(^{59}\) A “binary CDS or digital CDS” is where the protection buyer receives a specified fixed payment from the protection seller upon the occurrence of a credit event by the reference entity, rather than the seller compensating the buyer for the actual loss suffered, or having to pay the buyer par value for the reference obligation. See Durbin, supra note 1, at 69; Bendoranig, supra note 54, at 114 (describing fixed recovery swaps).

\(^{58}\) This description is based on the explanation provided in Durbin, supra note 1, at 66-68.

\(^{59}\) Id. at 68-69.
Another form of credit derivative can be the *collateralized debt obligation* (CDO). In general, a special purpose vehicle (SPV) is created that issues senior, mezzanine and sub (also called equity) debt to raise money to purchase a pool of financial assets, such as debt instruments (this is a cash CDO) or a *group of credit derivatives* (this is a synthetic CDO) or a mixture of the two (a hybrid CDO). The tranches (or levels of debt) each have their own risk rating and level of risk, with the senior tranche having the highest rating and lowest risk, while the equity tranche has the lowest rating and highest degree of risk. The equity tranche incurs all of the losses from the CDO’s investments, until the equity tranche is exhausted, and then the next lowest tranche will incur the losses, and so on up the hierarchy of tranches. The lower tranches provide a cushion for the higher tranches, ensuring that the higher tranches will not suffer any of the losses of an investment until the lower tranches are exhausted.

The potential return is positively correlated to the risk exposure of each tranche, with the equity getting the highest percentage return on their money, while the senior tranche gets the lowest percentage return. This allows the CDO to leverage its capital because the senior tranche typically invests the majority of the money, but is only making a small return, and the lower tranches that are making a higher return have only invested a relatively small amount of the CDO’s capital (enough for the CDO to have a comfortable cushion). This allows the CDO to reap a competitive return on its investments that far exceeds the return of the senior tranche, and while this return may be equal to or even lower than the return on the equity tranche, it is calculated on a much higher notional amount, thereby outpacing the return due to the lower tranches.\(^6\) The SPV in the CDO earns the difference in the spread between what it makes on a return for its investments and the aggregate amount of returns it has to pay to the various

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\(^6\) This description of CDOs is summary in nature, for a more comprehensive explanation, see Gary Barnett, *Understanding CDOs*, 891 PLI/Comm 769, (Nov.-Dec. 2006); Bendernagel, *supra* note 54, at 102-05.
tranches.

Hopefully, this small sample of types of credit derivatives illustrates the dynamic nature of the market. These instruments serve as the basis for a wide variety of variations on these basic concepts, with new innovations being introduced all the time.

Some innovations are products such as the target annual review note (TARN), constant proportion portfolio insurance (CPPI), and constant proportion debt obligations (CPDO). These are complex credit derivatives, and are briefly summarized here to show the innovation of the market.

In a TARN, capital is invested in a portfolio of positions. The TARN has a target return rate, the achievement of which is the goal of the investment. The TARN promises a 100% protected return of capital investment within a fixed maturity, with an annual coupon based on the worst performing stock in the selected portfolio. But, if the sum of all the coupons in the portfolio reaches the predetermined target return, the TARN is automatically redeemed early. This investment strategy is based on leverage and correlation. The more correlated the positions in the portfolio, the higher the chance of reaching the target return rate, and the greater the chance of an early redemption.

In CPPI, the investor is theoretically protected against loss, but still able to participate in and benefit from gains. CPPI depends on dynamic (or continuous) allocation between risky and non-risky positions (such as government bonds). Capital is allocated to the risky investment as it gains value, but re-allocated to a non-risky investment when the risky position is declining. By shifting more and more money to the non-risky investment during periods of declining value in the risky position, this strategy seeks to preserve a minimum return (usually a guaranteed return.

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61 While the TARN and CPPI investment strategies have been around for a while, they are becoming more prevalent and more widely applied as derivatives markets expand the base of positions to which they can be applied.
of principal). This strategy depends on high amounts of leverage to take advantage of the gains in the risky position when it is performing well, as well as constant monitoring of the fluctuations in the underlying position values to determine the proper allocation between risky and non-risky positions.63

Another relatively recent innovation in the credit derivatives market is the constant proportion debt obligation (CPDO).64 A special purpose vehicle is created, which issues highly rated bonds (usually AAA for both principal and coupon) to investors with a coupon rate of up to LIBOR + 200bp65 (in some cases even higher) with a long maturity date (usually at least 10 years). The SPV then invests that money in a pool of assets, to be used as collateral. The return on that pool of assets is then swapped with a bank in exchange for premiums that the bank receives as a protection seller in CDSs on a reference portfolio made up of credit indices, usually 50% each of the Dow Jones CDX (Investment Grade) and the iTraxx Europe (IG). These indices are composed of highly rated, stable companies, and the indices are rolled (i.e. rebalanced by determining which companies to include in the index) every six months – this leads to a relatively low risk of default on the CDSs because the index is monitoring the credit worthiness of the companies it lists.

The CPDO starts out highly leveraged (up to 15x) to build up a cushion between its investment returns (i.e. the premiums collected as protection sellers in the CDSs) and its coupon payments. Leverage is then decreased over time if the investments perform well, or maintained

64 This is a type of structured credit product introduced in 2006; it is discussed briefly to show the constant innovation in the credit derivative market. See Paul Davies, Questions lie behind CPDO hype The new kid on the block has made a big impact, but investors should take a long look before they leap, Fin. Times, Nov. 14, 2006, at 43 (discussing the impact of CPDOs on the credit market). Such innovation is a constant attempt to more efficiently allocate risk, and may not be possible if the market was directly regulated, as discussed infra.
65 LIBOR refers to the London Inter Bank Offer Rate, an interest rate that is published daily and commonly used as a reference rate in derivatives and other financial instruments. “bp” refers to basis point, i.e. 1/100th of a percent.
at a high rate if necessary to make up for any poor performance or defaults. A reserve is built up that will be used as a cushion for any future defaults and to pay back principal at the maturity date. This investment product has a high rating, but is not guaranteed – the initial investor is really taking an equity position in exchange for its principal investment, but in a strategy that has been modeled and tested to ensure a relatively high degree of certainty of payment of coupon and principal.\textsuperscript{66}

These brief discussions of basic types of credit derivatives and the more current complex adaptations are meant only as a broad overview, to convey the complexity and constant innovation of the credit derivatives market. The product descriptions were brief and summary in nature, not delving into many of the subtleties and intricacies that underlie these instruments, and were offered to establish a context in which to place the recent market developments.

As a final introductory note concerning credit derivatives, it is important to mention that credit derivatives can be settled in two ways: physical settlement and cash settlement. Upon the occurrence of a credit event that obligates the seller to compensate the buyer, physical settlement involves the credit protection buyer delivering to the protection seller the underlying reference obligation, in exchange for the par value of the reference obligation. For cash settlement, the protection seller merely compensates the buyer for the buyer’s net loss from the credit event by the reference entity. This is a simple form of netting, a concept which will be discussed infra, in the context of netting multiple transactions between parties.

\textbf{PART IV: The Recent Developments in the Credit Derivatives Market}

As mentioned above, the credit derivatives market has been developing very quickly over

\textsuperscript{66} This brief discussion of CPDOs in the preceding two paragraphs relied on information found at: Citigroup, Corporate and Investment Banking, \textit{CPDOs The New Best Seller} (Nov. 10, 2006) available at http://www.nuclearphynance.com/User%20Files/464/Citi_cpdos%20-%20the%20new%20best%20seller.pdf (giving a comprehensive discussion of CPDOs); Davies, \textit{supra} note 64, at 43 (giving a brief description of CPDO mechanics).
a relatively short period of time. This comment will focus on the recent industry initiatives that have helped shape that market during the last couple of years (2005-06), focusing on the fourteen dealers who, through a collective initiative, collaborated under the supervision of the Federal Reserve Bank of New York and other regulators, to solve the problems facing the market in 2005. Additionally, in Part VI, this industry initiative will then be discussed as a potential model for the future of U.S. regulation.

In February 2005, the Financial Services Authority (FSA) issued a letter “to all financial institutions that are active in the credit derivatives market,” calling attention to the widespread “level of unsigned confirmations” with some transactions remaining unconfirmed for months. The FSA recognized that credit derivatives provided a number of benefits, including as a tool for diversifying risk and a method for bringing increased liquidity to all segments of the credit market, but was concerned that operational deficiencies could have a potentially devastating impact on the global market through the misunderstandings and uncertainty that arise from unconfirmed transactions.

The FSA asked that individual firms consider their “operational processes and risk

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67 See text accompanying notes 38-40, supra.
68 The FSA is the United Kingdom financial markets regulatory body, it is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act of 2000. The FSA is accountable to the Treasury Ministers, and through them to Parliament. It is operationally independent of Government, and is funded entirely by the firms it regulates. See Financial Services Authority, Who are we, http://www.fsa.gov.uk/Pages/About/Who/index.shtml (last visited Feb. 1, 2007).
70 “A confirmation sets out the terms and conditions of a credit derivative transaction . . . . While the economic terms of the transactions can be agreed upon upfront, confirmation problems can be traced back to a number of non-economic, technical issues.” N.Y. Fed Said Pleased With Banks’ Plan To Address Key Credit Derivatives Issues, 37 Sec. Reg. & L. Rep. (BNA) [No. 40, at 1682] (Oct. 10, 2005). “Though transactions become legally binding once agreed to over the telephone, regulators are concerned that the backlog of confirmations would become an operational nightmare if credit markets were rocked by, for example, a series of corporate defaults.” N.Y. Fed Hails Banks’ Progress In addressing Credit Derivatives Issues, 37 Sec. Reg. & L. Rep. [No. 41, at 1713] (Oct. 17, 2005).
71 FSA Letter, supra note 69.
management frameworks – and the resourcing of these in relation to credit derivatives – to assess their robustness in this rapidly evolving market . . . . And more specifically [make sure that] the necessary steps are in place to tackle the level of outstanding confirmations in credit derivatives.”

A few weeks after the FSA letter, the Joint Forum issued a report, by its Working Group on Risk Assessment and Capital, on Credit Risk Transfer activity. This report contained seventeen recommendations to improve the present state of credit risk transfer (CRT) activity, “focus[ing] more narrowly on the newest forms of CRT, in particular on those activities associated with credit derivatives.” This report had several suggestions aimed directly at improving the credit derivatives market, but also acknowledged the “willingness of market participants to address such issues prior to specific regulatory pressures to do so, as well as the existence of effective mechanisms to undertake such collective efforts.”

The report identified four main issues in the credit derivatives market: (1) counterparty credit risk; (2) legal uncertainty; (3) timely matching and confirmations; and (4) what can broadly be characterized as model risk. The Joint Forum Report recommended that parties to credit derivative transactions take every effort to ensure that they are adequately assessing the

73 FSA Letter, supra note 69.
74 The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. See Bank for Int’l Settlements, Joint Forum Page, http://www.bis.org/bcbs/jointforum.htm (last visited Feb. 1, 2007).
75 Joint Forum, Credit Risk Transfer (Mar. 2005), available at http://www.bis.org/publ/joint13.pdf [hereinafter Joint Forum Report]. It should be noted here, that while the Joint Forum Report was published in March 2005, it was circulated for comment in October 2004, and was cited as a motivating force behind the FSA Letter urging the credit derivatives market to take action to improve its infrastructure. Id. at 1; FSA Letter, supra note 69, at 1.
76 Joint Forum Report, supra note 75, at 1.
77 Id. at 16 (pointing out issues where the market has taken upon itself to address perceived vulnerabilities: creating a database for CDS reference entity names, developing services to support matching and confirmation, development of standardized documents, and development of voluntary standards for appropriate use of non-public information).
78 Id. at 2-3.
risks posed by such transaction, including establishing the credit worthiness of counterparties, and assessing their aggregate risk to individual market participants.\textsuperscript{79} Other factors to consider were whether the models that participants were using were adequately assessing factors such as correlation and adequacy of collateral posted for transactions.\textsuperscript{80}

The Joint Forum Report also provided recommendations for improving legal certainty by stepping up efforts in standardization of documentation and increased automation, as well as being particularly careful with how parties handle confidential non-public information.\textsuperscript{81} The Joint Forum also echoed the concern of the FSA in the level of unsigned confirmations for transactions in the credit derivatives market, recommending greater implementation of automation in the confirmation process to address this issue. The report also commented on the issue of the practice of undocumented assignment of existing contracts to third-parties without the consent of the original counterparty.

In general, the report offered the above recommendations for the credit derivatives market, as well as the broader credit market recommendation that participants perform more comprehensive stress testing and scenario analysis that takes into account unfavorable changes in the currently benign market structure, focusing on the high concentration of risk in a relatively few number of market participants and the correlative effects that one such participant’s default would have on the market as a whole, and the effects particular to each participant’s aggregate

\textsuperscript{79} Id. at 25-29 (stressing the importance of parties conducting their own assessment of parties credit worthiness and not simply rely on external rating services, emphasizing that ratings across different types of investments do not necessarily correspond, \textit{i.e.} a AAA rating for a bond differs in risk profile from a AAA rating for a credit default swap).

\textsuperscript{80} Firms should dynamically (\textit{i.e.} constantly) reassess the amount of collateral required for a transaction, and not rely on a one-time calculation. Also, parties need to assess the correlative effects across their aggregate transactions, the possible correlations between the protection seller and reference entity, and the possible change in liquidity of contracts, especially complex products, in the face of a default buy a major market participant. \textit{Id.} at 29-30.

\textsuperscript{81} Id. at 31-34. The report highlighted problems associated with corporate and debt restructuring, and the effect on corresponding credit derivative reference obligations. It also pointed out the need for greater standardization in documentation to eliminate uncertainty and misunderstandings, especially as products become more complex. The report applauded ISDA for its part in creating many of the current standardized documents in the market, and encouraged the ISDA to continue its efforts in this area.
risk exposure.\textsuperscript{82}

In July 2005, another report highlighted critical deficiencies in the credit derivatives market infrastructure: the Counterparty Risk Management Policy Group II (CRMPG II) Report\textsuperscript{83}

The CRMPG II Report was a private sector initiative that voluntarily took action to provide a framework for financial stability. This report issued 47 Guiding Principles and Recommendations\textsuperscript{84} that should be used as a framework for anticipating, preparing for and preventing potential financial shocks to the global financial markets in this era of increasing complexity. Many of these principles and recommendations are applicable to the credit derivatives market, and some are specifically addressed to that audience.

One of the major issues in the credit derivatives market identified in the CRMPG II Report was the backlog of confirmations.\textsuperscript{85} The CRMPG II went as far as calling for an industry-wide meeting to address this problem:

CRMPG II endorses the convening of an industry-wide roundtable in the near term to focus on aggressively reducing confirmation backlogs by working toward further technological and operational enhancements, and by strengthening backoffice operations.\textsuperscript{86}

\textsuperscript{82} Id. at 35-36. Other general recommendations included ensuring that market participants employ sufficient personnel to deal with the increasing complexity of the credit markets, and the need for supervisors and management to take an active role in ensuring the adequacy of their entity’s risk management program.

\textsuperscript{83} COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (July 27, 2005), available at http://www.crmpolicygroup.org/ [hereinafter CRMPG II Report]. “On January 15, 2005, the organizational meeting of the Counterparty Risk Management Policy Group II (CRMPG II) was held in New York. CRMPG II is comprised of senior officials from major financial institutions and is chaired by E. Gerald Corrigan, Managing Director, Goldman Sachs and former NY Fed president. The primary purpose of CRMPG II — building on the 1999 report of CRMPG I — is to examine what additional steps should be taken by the private sector to promote the efficiency, effectiveness and stability of the global financial system.” Id. at 1. The CRMPG I report issued in 1999 had similar objectives: improving on “(i) counterparty credit assessment, (ii) risk management, measurement and reporting, (iii) market practices and conventions and regulatory reporting.” Zdenka Seiner Griswold, Counterparty Risk Management Policy Group II: OTC Documentation Practices in a Changing Risk Environment, SL047 ALI-ABA 177, 179 (Jan. 12-13, 2006) (offering a comprehensive discussion of the CRMPG II Report, particularly as it relates to the OTC derivatives markets).

\textsuperscript{84} CRMPG II Report, supra note 83, at 13-40 (listing the 47 Guiding Principles and Recommendations).

\textsuperscript{85} Id. at 74-76.

\textsuperscript{86} Id. at 75.
The CRMPG II recommended further development of automated trade processing and matching, such as electronic trade platforms, with the ultimate goal of “straight through processing,” as the best way to achieve increased efficiency in the market. Another major issue was netting. This is the process of settling transactions between parties by allowing off-setting obligations to cancel each other out: theoretically leading to a single payment from one party to its counterparty, regardless of the number of transactions between them. The CRMPG II Report recommended increased use of netting across like-kind obligations, cross-product obligations, across master agreements, and in collateral arrangements whenever the parties are certain of its legal enforceability.

The CRMPG also applauded the efforts that the derivatives market has made in standardization of documents and definitions, thanks in large part to the efforts of the ISDA, but emphasized the need for further progress in this area for greater legal and systemic certainty, as well as a necessary step in the furtherance of developing a greater degree of automation.

Other credit derivative specific issues included many of the same concerns voiced by the

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87 See id. at 77-84, discussing some of the automated trade matching and processing platforms available in the market, including DTCC (discussed infra at notes 108-10 and accompanying text), eConfirm, SwapClear, and Swapswire, and the benefits of these developing market innovations. The ultimate goal for the market should be straight through processing, which would “reduce[] the number and frequency of trade disputes and maximizes market efficiency, opportunity and access. STP therefore fosters legal, credit, market and operational certainty.” Id. at 84. Straight through processing has been the goal for many markets seeking to eliminate the need for human intervention in processing orders and confirmations, thereby expediting and reducing the possibility of mistakes in the process.

88 The CRMPG II cited approvingly the available netting possibilities in the DTCC and SwapClear, as well as the netting approach available in the IFXCO Master Agreement, the close out valuation methods in the ISDA Master Agreements of 1992 and 2002, the ISDA Bridge Agreement, Bond Market Association’s Cross-Product Master Agreements, and the legal opinions gathered by the ISDA in many jurisdictions, confirming the enforceability of its Bridge Agreement. See id. at 85-95. The IFXCO Master Agreement governs foreign exchange and currency derivatives. Id. The close out valuation methods in the 1992 ISDA Master Agreement (Market Quotation and Loss) and the method in the ISDA 2002 Master Agreement (Close-out Amount) provide for netting obligations under a single master agreement. Id. The ISDA Bridge and Bond Market Association Cross-Product Master Agreements provide for netting of obligations across more than master agreement. Id. The CRMPG II also applauded the efforts of many jurisdictions, including in the U.S. Bankruptcy Code and U.S. bank insolvency laws, for their efforts to adopt legislation consistent with netting enforcement. Id. at 93-94.

89 Id. at 101-105 (especially focusing on harmonization of documents for cross-agreement application).
Joint Forum, including: concern over the practice of assigning trades without consent,\(^{90}\) potential failures in properly assessing counterparty credit risk,\(^{91}\) possibility of unknown correlations,\(^{92}\) and legal risks that could be better avoided through greater standardization of documentation, with the ultimate goal of straight through processing.\(^{93}\)

The CRMPG II Report has one central theme: increasing complexity.\(^{94}\) This gives rise to the necessity for increased vigilance in monitoring and evaluation of risk management procedures and overall policies through improved stress testing, scenario analysis and modeling of risk.\(^{95}\) The CRMPG II Report was a foundational undertaking by the private sector that paved the way for the progress made by the credit derivatives market under the guidance of the Federal Reserve Bank of New York (NY Fed).

The CRMPG II called for an immediate “industry-wide roundtable . . . to focus on aggressively reducing confirmation backlogs.”\(^{96}\) The NY Fed was quick to respond, sending a letter to 14 key Wall Street firms on August 12, 2005, calling for such a meeting “to discuss how best to address a range of important issues in the credit derivatives market.”\(^{97}\) That meeting took place at the NY Fed on September 15, 2005, focusing on the problems with the practices of the credit derivatives market “with regard to assignments of trades and operational issues associated with confirmation backlogs.”\(^{98}\) Fourteen industry participants took part in the

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\(^{90}\) Id. at 115-16.

\(^{91}\) Id. at 110-12.

\(^{92}\) Id.

\(^{93}\) Id.

\(^{94}\) Id. at 10.

\(^{95}\) Id. at Section V.

\(^{96}\) See supra note 86 and accompanying text.


meeting, along with fifteen supervising/regulatory entities also in attendance. “The industry participants outlined a number of concrete steps to achieve [the] goals.”

On October 4, 2005, the fourteen industry participants (referring to themselves as the “Major Dealers”) sent a letter to the NY Fed, outlining their collective progress and an update on the “next steps toward improving Credit Derivatives industry practices and confirmation backlogs.” The Major Dealers stated that they had met regularly since the Sept. 15, 2005 meeting at the NY Fed, and had established an initial framework for improving the infrastructure of the market by:

- committing to provide monthly metrics,
- committing to implement and adhere to the ISDA 2005 Novation Protocol

99 For a list of the industry participants and supervising entities in attendance, see Fed. Reserve Bank of N.Y., List of Attendees, at http://www.newyorkfed.org/newsevents/news/markets/2005/DerivativesParticipants.doc (last visited on Feb. 2, 2007). Many of these participants were also involved in CRMPG II.

100 NY Fed Press Release, supra note 98; see Wall Street Firms to Submit Plan to Shrink Confirmation Backlog, 37 Sec. Reg. & L Rep. (BNA) [No. 39, at 1632] (Oct. 3, 2005) (stating that the next step in the process would be a plan in the form of a letter from the market participants which would be released in early Oct. 2005).


103 First Industry Letter, supra note 102 (providing data to be used internally by supervisors, to measure progress on trade volumes, confirmations, settlements and fails).

104 Id. The Major Dealers commit to set an effective date for the ISDA 2005 Novation Protocol of October 24, 2005, and to finalize a Guide to support implementation of that Protocol. Id. The highlights of the Guide include: (1) obligation of the transferor to obtain written consent from the remaining Party on the novation trade date; and (2) a process for notification and method for communication. Id. A novation is “[t]he act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party. BLACK’S LAW DICTIONARY (8th ed. 2004). In this context, it deals with one counterparty assigning its obligation to a contract to another party, often without informing or getting the consent from its original counterparty.

105 The ISDA 2005 Novation Protocol amends the ISDA Master Agreements to allow for the transfer of an obligation or interest under the requires Agreement without written consent of the Remaining Party (i.e. email and
• establishing target dates and levels by which to aggressively reduce confirmation backlogs and reviewing the standards by which the current process is performed to ensure delivery within five days;¹⁰⁶
• committing to move the industry, over time, to a T + 5 standard for vanilla confirmations;¹⁰⁷
• committing to fully use the DTCC¹⁰⁸ in its existing functionality, and requiring all active clients to subscribe to industry-accepted electronic trading platforms¹⁰⁹
• continuing to encourage all clients to sign up with DTCC¹¹⁰
• continuing to refine the cash settlement process for integration into master confirmations for North American index contracts; and using protocols and the auction process in the event of any credit events in the interim;¹¹¹ and

fax consent is satisfactory). Int’l Swap & Derivatives Ass’n, 2005 Novation Protocol, (published Sept. 12 2005), available at http://isda.org. All adhering parties, when in the position of Transferor, are required to obtain consent from the Remaining Party on the day of proposed novation, and provide detail sufficient to identify the transaction being transferred, and upon consent of the Remaining Party, provide notice of that consent to the Transferee. Id. at Annex 1. When in the position of the Remaining Party, adhering parties may withdraw consent to a novation for any reason, but must provide notice of whether it consents to the Transferor by 6:00 p.m. on the day of the novation. Id. When in the position of Transferee, upon notice of consent by the Remaining Party it must confirm all relevant details of the transaction being transferred. Id. If consent is not provided by the Remaining Party, the rights and obligations vis a vis the Transferor and Transferee are still in effect, but the Transferor effectively becomes a “pass-through” and acts as a conduit whereby the obligations of the Transferee and Remaining Party flow through the Transferor, but Transferor remains as counterparty to both, rather than stepping out of the transaction and allowing the Remaining Party and Transferee to become counterparties. Id. All novations will be documented by all parties entering into a Novation Confirmation as soon as practicable after the novation. Id; see also Guide to Implementation of the 2005 ISDA Novation Protocol, available at http://isda.org (offering a comprehensive explanation of the novation terms in the Protocol).
¹⁰⁶ The Major Dealers committed to make significant progress on the reduction of their backlogs. First Industry Letter, supra note 102. “The Major Dealers commit that by January 31, 2006, we will each reduce our number of confirmations outstanding more than 30 days by 30% from our number of confirmations outstanding more than 30 days as of September 30, 2005 . . . . The Major Dealers commit to set a further aggressive target for March 31, 2006. We will finalize this target by December 15, 2005, when we expect to have substantial knowledge of the impacts of automation advances, lock-ins, and the Novation Protocol.” Id.
¹⁰⁷ The ultimate goal will be moving the industry to a standard of all vanilla (plain or simple) confirmations taking place within 5 days after the trade or transaction and to “dramatically increase utilization of automated matching through DTCC and to change the current market practices on novations [which] will lay the foundation for moving to that standard, which will be met through high levels of automated processing.” Id.
¹⁰⁸ The Depository Trust & Clearing Corporation (DTCC) provides electronic clearance, settlement and information services for a wide range of derivative products, including OTC derivatives. DTCC, About DTCC: Who We Are, http://www.dtcc.com/AboutUs/index.htm (last visited Feb. 3, 2007). DTCC Deriv/Serv is a matching and settlement service that provides for payment netting and settlement, and can accommodate virtually all standard credit default swap transactions; it has gained wide industry acceptance globally and is partnered with the Reference Entity Data (RED) service. DTCC, DTCC Deriv/Serv, http://www.dtcc.com/ProductsAndServices/derivserv/index.htm (last visited Feb. 3, 2007).
¹⁰⁹ The Major Dealers committed to fully using DTCC existing functionality by October 31, 2005. It will also require all active clients to subscribe to DTCC or alternative industry accepted electronic matching platforms, by January 15, 2006, and require all clients who trade on average one time per week over the prior three months to subscribe and use DTCC by March 31, 2006. First Industry Letter, supra note 102.
¹¹⁰ Id.
¹¹¹ The Major Dealers worked with the ISDA to complete the Delta & Northwest CDS Index Protocol to deal with the settlement of contracts to which Delta and Northwest were reference entities after the two airlines filed for bankruptcy. Thanks in large part to the efforts of the ISDA and industry participants, the obligations of Delta and Northwest were settled without the chaos predicted by some in the face of a large reference entity default. See e.g.
• active use of the “tear up” process to reduce open trades in distressed names.¹¹²

The Major Dealers followed their first letter with a second in December 2005, again reporting their progress and setting a second target date and level for reduction of outstanding confirmations.¹¹³ Another meeting of the Major Dealers at the NY Fed was scheduled for February 16, 2006 to discuss the progress on the commitments outlined in the two letters.¹¹⁴ After that February meeting, the NY Fed announced that it was encouraged by the progress that the Major Dealers had made in fulfilling the commitments outlined in their first letter, and their commitment to continue working together on those issues.¹¹⁵ The Major Dealers had exceeded their target level of 30% reduction in unconfirmed trades for January, and as a whole had achieved a 54% reduction.¹¹⁶ The Major Dealers had also adhered to the ISDA 2005 Novation Protocol for the assigning of trades, and increased use of electronic trade processing from 46% in September 2005 to 62% by January 2006.¹¹⁷ The NY Fed was quoted as saying, “the industry

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¹¹² The Major Dealers scheduled an industry tear up on October 7, 2005. First Industry Letter, supra note 102.
¹¹⁶ Id.
¹¹⁷ Id.
group is committed to continue making progress in these areas and . . . will outline a set of conditions that would define acceptable market practices for post-trade processing.”

Following the February meeting at the NY Fed, the Major Dealers sent a third letter to the NY Fed. They outlined further steps they were planning to take to improve the infrastructure of the credit derivatives markets:

- moving towards a largely electronic market place;
- developing standard industry timelines for affirmation and confirmation of trades;
- developing an “industry trade warehouse;”
- developing new procedures for settlement following a credit event,

118 N.Y. Fed Pleased by Banks’ Progress In Addressing Credit Derivatives Targets, 38 Sec. Reg. & L. Rep. (BNA) [No. 9, at 321] (Feb. 27, 2006); see also Henry Sender, Moving the Market: Concerns Dog Credit Derivatives --- Industry Group Symposium Explores Market Imbalances Bankruptcies May Trigger, WALL ST. J., Mar. 1, 2006, at C3 (discussing the progress made in the credit derivatives market since the first Major Dealer meeting, but recognizing that there is still work to be done, especially with regard to issues such as stress testing and scenario analysis which need to take into account the possible strain caused by the exit of a major player in the credit derivatives market which has a concentrated dealer base).


120 The Major Dealers committed to implementing industry wide best practice guidelines, which include processing electronically all trades that are so capable of being processed (called Eligible Trades), with straight through processing as the ultimate industry goal. Id; see also Credit Derivatives Dealers Issue New Set Of Commitments For Industry improvement, 38 Sec. Reg. & L. Rep. (BNA) [No. 12, at 478] (March 20, 2006) (quoting Corrigan [former NY Fed chairman, and organizer of CRMPG II] as saying that straight through processing that would require virtually no human intervention is a key long term industry goal).

121 “Details of Eligible Trades should be submitted to the relevant Electronic Platform by no later than T + 1 business day and matched/affirmed (and any rejections/exceptions/discrepancies resolved) no later than T + 5 business days. Confirmation for non-Eligible Trades should be issued no later than T + 10 calendar days.” Third Industry Letter, supra note 119. All trades should be confirmed (or resolved) no later than T + 30 calendar days. Id.

122 The Major Dealers were working with DTCC to create a “a central trade information warehouse for credit derivatives - essentially a comprehensive database containing the ‘golden copy’ of each contract – and a central support infrastructure that standardizes and automates downstream processes throughout the life of each contract.” Id. The DTCC Deriv/Serv Trade Information Warehouse was launched in September 2006. See DTCC Deriv/Serv, Trade Information Warehouse A Practical Guide for the Buy Side, http://derivserv.dtcc.com/binary/31182A%20Practical%20Guide--%20Release10-06.pdf (last visited Feb. 3, 2007) (a comprehensive description of the services provided by Deriv/Serv and the Trade Information Warehouse). “The initial Warehouse Eligible Transactions will be single name CDS (both corporate and Sovereign using master confirmation agreements, default master confirmation agreements or the ISDA physical settlement matrix), CDS Index products, and Tranch Index products, all being confirmable through Deriv/SERV confirmation services as of June 1, 2006.” BOND Mkt. ASS’N, THE ASSET MANAGERS FORUM WEEKLY RPT., AMD Speaks on CDS Automation, Sept. 22, 2006, available at http://www.theassetmanager.com/WeeklyReport/092206.html (discussing the DTCC Trade Information Warehouse); see also Clearing the Derivatives Backlog, DIALOGUE THE VOICE OF THE SWIFT COMMUNITY, (Q2 2006), at 22.

123 The Major Dealers were working with the “ISDA, the members of CDS IndexCo LLC and International Index Company, and various service providers to develop a new framework for the settlement of credit derivatives
• further reduction in unconfirmed confirmations.\textsuperscript{124}

The Major Dealers pledged “ongoing commitment to maintaining industry momentum.” They recognized that “[w]e may find that a tactical step that we think will solve the problem today may not, without modification, get us all the way to the steady state.”\textsuperscript{125}

The NY Fed was again “encouraged by the cooperation and progress made to date.”\textsuperscript{126}

At a meeting in Washington in June 2006, Federal Reserve Board Governor Susan Schmidt Bies, stated “[w]e are generally pleased with both the industry's self-identification of the issues and its commitment to making improvements.”\textsuperscript{127}

The Major Dealers continued their efforts at maintaining the momentum of their industry initiative, calling for greater participation by the industry in a July 2006 letter to their fellow credit derivatives market participants.\textsuperscript{128} The Major Dealers called for increased support to realize industry-wide targets, such as: comprehensive timelines for all trade confirmations, continued progress towards electronically confirming a higher percentage of trades for all credit derivative products, adoption of new DTCC functionality, backloading existing transactions onto the DTCC (or equivalent), continued diligence in prompt execution of novations, standardized and harmonized documentation and procedures for all transactions, and for all market participants to ensure that they had the resources in place to conform to all industry best contracts following a credit event. The settlement solution will provide for net physical settlement at a single auction-based price.” Third Industry Letter, supra note 119.

\textsuperscript{124} “Each Major Dealer commits to a 70% reduction in its number of confirmations outstanding for more than 30 days on June 30, 2006 from those outstanding more than 30 days on September 30, 2005.” Id.

\textsuperscript{125} Id.

\textsuperscript{126} Id.


A third meeting of the Major Dealers and their regulators was held at the NY Fed on September 27, 2006. The NY Fed reviewed the progress made by the Major Dealers over the last year:

- ended the market practice of assigning trades without obtaining prior consent of the counterparties,
- reduced the number of all confirmations outstanding by 70 percent and confirmations outstanding for more than 30 days by 85 percent,
- doubled the share of trades that are confirmed on an electronic platform to 80 percent of total trade volume, and
- agreed upon a protocol for the settlement of a credit event.

The NY Fed remarked that “it is important that the market participants sustain their progress toward a more automated post-trade processing environment where the vast majority of trades are now processed electronically and where there are strong risk mitigants for more complex trades,” as well as “robust adoption” of the new DTCC Deriv/Serv Trade Information Warehouse.

The regulators, apparently content with the progress made to date, and the commitment to continue to improve, expressed looking forward to the industry making similar improvements in equity derivatives trading.

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129 Letter to Market Participants, supra note 128. See Credit Derivatives Dealers Cut Backlog of Confirmations by 80 Percent, 38 Sec. Reg. & L. Rep. [No. 30, at 1270] (July 24, 2006) (discussing the progress made by the Major Dealers to date, and goal of fully automated processing as the long-term industry goal).


131 Id.

132 Id. See Credit Derivatives Market Swells to $26 Trillion in Year, Association Says, 38 Sec. Reg. & L. Rep. (BNA) [No. 38, at 1590] (Sept. 25, 2006) (discussing the new statistics announced by the ISDA on Sept. 19 and quoting Geithner as being happy with the progress made in the credit derivatives market, but also mindful of the need to remain vigilant).

133 NY Fed Press Release, supra note 130. See Letter from Senior Mgmt. of the 17 Industry Participants, to Timothy Geithner, Pres. of Fed. Reserve Bank of N.Y. (Nov. 21, 2006), available at http://newyorkfed.org/newsevents/news/markets/2006/an061121c.pdf (committing to take similar initiatives in the equity derivatives markets, as had been made over the course of the last fourteen months in the credit derivatives markets, including: increased automation and reduction of unconfirmed transactions). This commitment was welcomed by the NY Fed, which hoped to see similar progress made in the equity derivatives markets. Press Release, Fed. Reserve Bank of N.Y., New York Fed Welcomes Industry Commitments on Equity Derivatives (Nov.
Discussion of the Industry Initiative in the Credit Derivatives Market

In little over a year, the Major Dealers were able to make remarkable improvements in the infrastructure of the credit derivatives market. Through collective effort they were able to make an 80% reduction in the level of unconfirmed trades, and implemented a clear industry-wide protocol to stop novations without consent. Both problems, if left unchecked, had the potential for widespread systemic uncertainty in the face of an unfavorable economic downturn or a default by a heavily referenced entity. This brings up another point which should be emphasized: this initiative was a prophylactic effort, and not the result of immediate economic necessity due to a financial shock. This allowed the market to develop practices and strategies for long-term success rather than applying a quick-fix to an immediate problem.

The success of the Major Dealers depended in large part upon the efforts of not only themselves, but industry associations, such as the ISDA, and other entities that serve the

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134 There have been some minor events that have shaken the credit derivatives markets, but these have been dealt with, notably: (1) the bankruptcy filings of Northwest, Delta, Dephi, and others; and (2) in May 2005, the unanticipated correlative effects of General Motors rating falling to junk status and the sharp fall in their bond prices had effects on credit derivative portfolios and indices which contradicted the models upon which traders had relied. See Riva D. Atlas, A Relief: Some Gains For Hedges, N.Y. TIMES, June 8, 2005, at C1; Jonathan Fuerbringer & Danny Hakim, Fitch Cuts G.M. to Junk, Citing Poor S.U.V. Sales, N.Y. TIMES, May 25, 2005, at C3; Mark Whitehouse, et. al, The Sky Darkens for Bondholders -- Backfiring Bets on Derivatives, Corporate Executives Allegiances are Among Worries Raising Risk, WALL ST. J., May 12, 2005, at C1.

135 ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 750 member institutions from 52 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of
technical needs of the market, such as DTCC. The ISDA was an integral participant in developing standardized documentation for transactions and creating protocols in the areas of novations, collateral arrangements, settlement and netting. The Major Dealers also relied heavily on continued dialogue with the Managed Fund Association\textsuperscript{136} and Asset Managers Division of the Bond Market Association.\textsuperscript{137} These two Associations were instrumental in the progress made by the Major Dealers.\textsuperscript{138}

The achievements of the Major Dealers in reducing backlogs and implementing consent-required novation practices are all derived from the success of the market in developing and applying a greater degree of standardization and automation.

The ISDA paved the way for harmonization and standardization in documentation in OTC derivatives. One of the first of such efforts was the 1992 Master Agreements, followed by derivatives and risk management from public policy and regulatory capital perspectives. ISDA, About ISDA, http://isda.org.

\textsuperscript{136} MFA, headquartered in Washington, DC, is the primary trade association representing professionals who specialize in alternative investment strategies including hedge funds, funds of funds and managed futures funds. MFA’s over 1,200 members are affiliated with the majority of the 100 largest hedge funds, which manage a significant portion of the over $1.2 trillion invested in hedge funds. Since its inception in 1991, MFA has provided industry leadership in government relations, communications, media relations, and education to MFA members and investors. Press Release, Managed Funds Ass’n, MFA Applauds Recommendations by Senator Schumer and Mayor Bloomberg (Jan. 29, 2007), available at http://www.mfainfo.org/images/PDF/Schumer_Bloomberg.pdf.

\textsuperscript{137} The Bond Market Ass’n merged with the Securities Industry Ass’n to form the Securities Industry & Financial Markets Ass’n (SIFMA) as of November 1, 2006. See Out of the Alphabet Soup: SIFMA, WASH. WIRE, Nov. 1, 2006, http://blogs.wsj.com/washwire/2006/11/01/out-of-the-alphabet-soup-sifma/; see also Press Release, The Bond Market Ass’n & Securities Industry Ass’n, SIA/BMA Merger Approved by Members, SIFMA Transition Begins: Joint Statement (July 27, 2006), available at http://www.bondmarkets.com/story.asp?id=2536 (discussing the shareholder approval of the merger). SIFMA is an “organization is passionately dedicated to representing more than 650 member firms of all sizes, in all financial markets in the U.S. and around the world. We are committed to enhancing the public’s trust and confidence in the markets, delivering an efficient, enhanced member network of access and forward-looking services, as well as premiere educational resources for the professionals in our industry and the investors whom they serve.” SIFMA, Welcome to SIFMA.org, http://www.sifma.org/section.cfm/about (last visited Feb. 4, 2007).

\textsuperscript{138} See Third Industry Letter, supra note 119 (acknowledging the contributions made by these Associations); see also MANAGED FUNDS ASS’N, STATE OF SUPPORT IN RESPONSE TO THE MAJOR DEALERS’ STEADY STATE PROPOSAL (Mar. 13, 2006), available at http://www.mfainfo.org/images/PDF/MFA_Fed14Stmt_3_13_06.pdf (discussing the Major Dealers initiative and the MFA’s continuing support in that undertaking).
the revised Master Agreement in 2002. The ISDA has also developed protocols for Credit Support/Margin and Novation, as well as publishing Definitions and gathering legal opinions on issues facing the enforcement of ISDA documentation. Another important function of the ISDA has been the development of protocols for the settlement of obligations following credit events by the reference entity. Another important contribution is the creation

139 When two parties negotiate and sign an ISDA Master Agreement, they agree upon the ongoing legal and credit relationship between them. While they can, of course, agree to amend the terms of their agreement at any time, there is no need to negotiate a whole host of issues each time they enter into a new transaction. Also, unlike many other financial master agreements, the ISDA Master Agreement can be used to document a range of different types of transactions (it is "multi-product"). Allen & Overy, LLP, An Intro. to the Documentation of OTC Derivatives “Ten Themes” 2 (May 2002), available at http://isda.org/educat/pdf/ten-themes.pdf (providing a comprehensive explanation of the structure and format of the standardized documents created by the ISDA for the OTC derivatives markets). Each individual transaction between two parties to a Master Agreement becomes a supplement to the Master Agreement, and therefore incorporates all of the terms agreed to by the parties in that Agreement, allowing parties to negotiate only the economic terms for each transaction, rather than entire separate comprehensive agreements. Id. at 2-3.

140 Credit support (a/k/a collateral, or margin) is the assets that parties reserve and designate to ensure that an obligation will be fulfilled, thereby reducing counterparty credit risk. The ISDA published four Credit Support Annexes and Deeds in the mid-1990s, but “[t]he 2001 ISDA Credit Support Protocol offers market participants the ability to amend the 1994 ISDA Credit Support Annex (New York law) and/or the 1995 ISDA Credit Support Annex (English law). Specifically, market participants may elect to amend provisions relating to transfer timing, dispute resolution, substitutions or exchanges of credit support and certain definitions.” See ISDA, 2001 ISDA Credit Support Protocol, http://isda.org; see also Allen & Overy, supra note 139, at 5.


142 “When used in the ISDA sense, "Definitions" are the various booklets of standard definitions and other terms and provisions published by ISDA for use in documenting different types of derivatives transactions. Generally, and broadly, each set of Definitions provides relevant terms for documenting a particular type of derivatives transaction. . . . [S]hort-form Confirmations rely on Definitions. They do this by stating that they incorporate a particular set (or sets) of Definitions. However, while they do a lot of the work for the parties, ISDA Definitions do not take care of everything. The Definitions themselves only provide a framework for documenting a transaction. It is still up to the parties to make various choices and to document the economic terms of the transaction itself in the short-form Confirmation. The parties are also free, of course, to amend the terms of the relevant Definitions or include additional provisions in the short-form Confirmation itself. While the terms of the Definitions represent the result of an extensive industry consultation process, they will not be appropriate for documenting all transactions without amendment or additional provisions.” Allen & Overy, supra note 139, at 3.

143 The ISDA gathered legal opinions in many jurisdictions relating to collateral arrangements, netting, and novation. These opinions are available to members to ensure that the ISDA documentation in these areas is enforceable. See Allen & Overy, supra note 139, at 5.

144 The ISDA created ad hoc protocols to deal with settlement of obligations that became due when a reference entity experienced a credit event. These protocols typically involve an auction methodology that facilitates settlement through bidding on acceptable terms of physical and cash settlement. See http://isda.org for a list of protocols that have been developed to deal with the settlements due to the credit events of Dura Operating Corp.
Also integral in developing a greater degree of automation were services such as the DTCC Deriv/Serv,146 which made substantial progress in increasing the functionality of electronic trade processing. DTCC Deriv/Serv Trade Information Warehouse147 is a massive undertaking that will revolutionize the OTC derivative market. A centralized repository for all transactions will promote efficiency in all aspects of trading: confirmations, processing, novations and settlement. The efforts of the DTCC should be looked at in conjunction with the collective effort of the Major Dealers – the developments would most likely have not been so aggressively pursued if it were not for the joint commitment to automation by the collective market.

The regulatory agencies also played a vital role in the improvements in the credit derivatives market, both through what they did do, and what they did not do. While the success of the industry initiative should be attributed to the market participants, it was the instigation148 of the regulatory agencies and threat of their intervention which initially provoked the efforts of the Major Dealers:

All of the dealers recognized the current weaknesses of their methods and were desirous of change. However, no individual dealer could have unilaterally

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145 “FpML® (Financial products Markup Language) is the business information exchange standard for electronic dealing and processing of financial derivatives instruments. It establishes a new protocol for sharing information on, and dealing in swaps, derivatives and structured products. It is based on XML (Extensible Markup Language), the standard meta-language for describing data shared between applications. All categories of over-the-counter (OTC) derivatives will eventually be incorporated into the standard.” FpML, What is FpML?, http://www.fpml.org/factsheet.html (explaining the development of this standardized “language” for communicating details of financial transactions which is a necessary step in increasing automation, as well as the benefits of such standardization and automation as opposed to the manual process of derivative trading).

146 See supra notes 108-10, and accompanying text for description of DTCC Deriv/Serv.

147 See supra note 122, discussing the Trade Information Warehouse.

148 Particularly the NY Fed call for a meeting of the fourteen major market participants, see supra note 97 and accompanying text. See also FSA Letter, supra note 69.
adopted procedures without the cooperation of the broader group. Today, after the intervention of the regulators, the infrastructure that supports the credit derivatives market is substantially stronger.\textsuperscript{149}

As important as the instigation of the process was, this comment argues that the stepping back of the regulatory agencies into a passive role was equally critical to the success that was achieved. This put the burden on the market participants to come up with solutions best fitted to the conditions that existed in the market, a task for which they, who collectively constitute that market, are best suited because of their day-to-day experience – much more so than regulatory agencies who are removed from the actual market and not in touch with the constant changes taking place at the market level.

*Success of the Initiative*

The question of how successful was the Major Dealer credit derivatives market initiative, has many facets. As far as operational risks, the market made extraordinary advances in less than a year to clear 80% of unconfirmed trades. Through collective effort and reliance on membership organizations such as the ISDA, the market as a whole has made drastic increases in the degree of automation and standardization of trades. There is wide adherence to the ISDA Novation Protocols, for consent-required assignment of trades. All of which lead to greater operational efficiency and legal certainty. In April of 2006, one U. K. regulator commented:

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\text{[T]he credit derivative exercise is well on its way to becoming an excellent example of the ability of the industry to solve a problem when it puts its mind to it as well as an excellent example of the ability of industry and regulators from around the world to work together to resolve market issues without resorting to}\\
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\textsuperscript{149} Annette L. Nazareth, Commissioner, Securities and Exchange Commission, Remarks Before the Brooklyn Law School Symposium on the Structure of Securities Markets (Nov. 10, 2006), available at http://sec.gov/news/speech/2006/spch111006aln.htm. While this author agrees with the proposition that regulatory agencies were the “impetus” for the Major Dealers collective efforts, I do not agree with the characterization of this speech that the success in the credit derivatives should be attributed to regulatory intervention. See id. As will be discussed, infra, the role that the regulatory agencies played was vital, but limited, which was in itself a major factor in the success of the initiative.
writing new rules.\textsuperscript{150}

This comment highlights the great success of implementing an industry initiative process to solve market problems, but as that regulator pointed out in his address: there is still work to be done. An 80\% reduction in unconfirmed trades is an impressive improvement, but there are still a significant percentage of trades that remain unconfirmed. While the risk posed by unconfirmed trades has been considerably lessened, it still remains a potent risk to the market, which must be eradicated (and it should be noted, the progress continues).

Further progress in the credit derivatives market can be seen by the pledge of twelve trade associations, including the ISDA and SIFMA, to “enforce strict self-discipline and to educate their members and others on how material nonpublic information should be handled.”\textsuperscript{151}

This pledge comes in response to concerns that the pricing of credit default swaps was moving suspiciously just before the announcements of leveraged buyouts of the reference entity.\textsuperscript{152}

Another issue that remains on the forefront of the credit derivatives market how the market will develop in light of the creation of futures trading in credit derivatives.\textsuperscript{153}


\textsuperscript{151} Serena Ng, Moving the Market – Tracking the Numbers/Street Sleuth: Trade Groups Are Agitating Over Apparent Leaks on Street – Stock & Bond Ass’n, Others Respond to Unrest Over Recent Market Activity, WALL ST. J., Dec. 14, 2006, at C3.

\textsuperscript{152} Id. This pledge also came in the face of recognition that the regulatory agencies, i.e. the SEC and CFTC, had no authority to regulate CDSs. See Kara Scannell, Serena Ng & Alistair MacDonald, Can Anyone Police the Swaps?, WALL ST. J., Aug. 31, 2006 (stating that the ISDA says that the SEC, which has not brought any actions in relation to the CDSs, has no jurisdiction because the swaps are private contracts, and that the CFTC itself says it has no oversight).

Other important risks still remain prevalent in the credit derivatives market: *model risk* and *risk of systemic financial shocks*. These risks are interrelated, both becoming more prevalent and harder to calculate as financial products become more complex and harder to model. Pricing of a position depends on the return that position offers, but also the risk that the position poses. The CRMPG II Report and the Joint Forum Report both advocated better risk management practices through more comprehensive stress testing and scenario analysis. Those reports pointed out the risk posed by unknown/uncalculated correlations, which could lead to systemic loss if one default or shock triggers others – creating a domino effect.

Unfortunately, these risks are hard to mitigate in the market through collective action. It depends on prudent risk management policies (hedging positions through diversification to minimize risk concentration) and proper attention to correlation in price modeling and overall risk management models. This is the province of individual firm policy, and there is no objective measure of effectiveness for each entity’s stress testing and scenario analysis practices.

The real measure of the success of these efforts will probably not be able to be

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154 The risk that your pricing models are not correct, *i.e.* do not provide adequate compensation for the risk that you incur in a position. See *Durbín*, supra note 1, at 191.


156 See *Banks Chart Significant Progress Toward Key Mgmt. Goals*, 38 Sec. Reg. & L. Rep. (BNA) [No. 10, at 366] (Mar. 6, 2006) (quoting E. Gerald Corrigan, chairman of CRMPG II, “As complex as it is today, its going to get more complex – there’s no question about that”). Corrigan also said that this will require market participants to strengthen valuation practices, use more sophisticated tools to evaluate the relationship between risk and capital, liquidity and margin, and increase focus on comprehensive forms of stress testing and scenario analysis. *Id.*


determined until a truly devastating shock to the market. Therefore, it is up to each market participant to satisfy itself that it is making sound decisions and implementing sound policies to deal with these risks and the market as a whole will have to wait until a catastrophic event impacts the market to find an objective measure of those efforts.

**PART V: Broader Recent Regulatory Concerns**

As foreign markets develop and become more stable, they become increasingly attractive alternatives to U.S. markets.\(^{159}\) This increase in global competition has led many to begin re-evaluating U.S. regulation of financial markets.\(^{160}\) The U.S. has a fragmented regulatory approach for dealing with the financial world. The banks are regulated by a set of groups,\(^{161}\) securities by another,\(^{162}\) commodities and futures by another\(^{163}\) and insurance companies by still another assemblage of regulators.\(^{164}\)\(^{165}\)

This fragmentation leads to redundancy, which increases costs and reduces efficiency. Compounding the problem is the internal overlap of regulatory authority within each individual

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\(^{161}\) Banks are regulated by the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corp., and the Office of Thrift Supervision.

\(^{162}\) Securities industry is regulated by the Securities Exchange Commission as well as those self-regulatory organizations to which the SEC has delegated authority, and is subject to state regulation from the Blue-Sky Laws.

\(^{163}\) The futures and commodities industries are regulated by the Commodity Futures Trading Commission and the SROs to which it has delegated rulemaking authority.

\(^{164}\) The insurance industry is regulated by the states, with each state having its own set of regulations. The regulation of the insurance industry is the epitome of the redundant and inefficient form of regulation that this comment is arguing must be changed. In the insurance industry, each state maintains its own rules and regulations making every decision made by insurance companies dependent upon maintaining compliance with and seek approval from dozens of regulatory agencies each with its own standards.

\(^{165}\) See McKinsey Report, *infra* note 184, at 81 (Exhibit 21: The U.S.’ Regulatory Regime is Complex and Fragmented, illustrating the numerous regulators assigned to regulate each component of the financial services markets).
framework. As a consequence, the fragmented U.S. financial regulatory system has become increasingly filled with friction and even dysfunctional.

In today’s financial reality, we must ask the question: does this artificial compartmentalization of industries create a regulatory framework that is best suited for the way that markets actually function? More and more complex financial products are developed which reference not only securities and bonds, loans, futures, commodities, and every combination thereof that can be conceived, but also synthetic positions that can be based on nothing more than abstract market perceptions at a given moment. Recognizing this reality, the question then evolves into how best to overlay the U.S. regulatory framework over the changing markets.

In November 2006, the Committee on Capital Markets Regulation (CCMR) issued an Interim Report. This report is specifically addressed to the President of the United States, in hopes that he will direct the President’s Working Group on Financial Markets to “implement reforms to protect the competitiveness of the U.S. public capital markets.”

The CCMR Report finds that the U.S. financial markets are suffering from a loss of

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166 See Judith Burns & Randall Smith, SEC Chairman Backs Creation of One Regulator for Brokerages, WALL ST. J., Nov. 11, 2006, at B3.
167 CCMR Report, supra note 159, at 67 (Nov. 30, 2006); See Markham, supra note 18, at 319-374 (discussing U.S. specifically focusing on securities and commodities and futures markets, and modern problems facing the regulation of these markets, as well as the conflicts between the SEC and CFTC over jurisdiction).
168 See SECURITIES INDUS. & FIN. MKTS. ASS’N, REINVENTING SELF-REGULATION, WHITE PAPER FOR THE SECURITIES INDUS. ASS’N (2000, updated Oct. 14, 2003) available at http://www.sia.com/market_structure/html/siawhitepaperfinal.htm (discussing securities regulation and offering six options for alternative regulatory models, ranging from maintaining the status quo to forming a single governmental regulatory organization); Jake Keaveny, Note, In Defense of Market Self-Regulation, An Analysis of the History of Futures Regulation and the Trend Toward Demutualization, 70 BROOK. L. REV. 1419 (arguing “that the self-regulatory model, while in need of some type of reform, will survive the latest round of scrutiny because time has shown that it is the most efficient and practical alternative.”)
169 “The Committee on Capital Markets Regulation is an independent, bipartisan committee composed of 22 corporate and financial leaders from the investor community, business, finance, law, accounting, and academia. Announced on September 12, 2006, its purpose is to explore a range of issues related to maintaining and improving the competitiveness of the U.S. capital markets. Our objective is to recommend policy changes that should be made, or areas of research that should be pursued, to preserve and enhance the balance between efficient and competitive capital markets and shareholder protection. This interim report focuses on equity capital markets. During the next two years, our Committee will continue to explore issues affecting other aspects of the competitiveness of U.S. capital markets.” CCMR Report, supra note 159, at vii.
170 Id. at 1.
competitiveness due to: “(i) an increase in the integrity of and trust in major foreign public markets resulting from more transparency and better disclosure; (ii) a relative increase in the liquidity of foreign and private markets, thus making it less necessary to go to the U.S. public equity capital markets for funding; (iii) improvements in technology, making it easier for U.S. investors to invest in foreign markets; and (iv) differences in the legal rules governing the U.S. public markets and the foreign and private alternatives.” These factors are all explored at length in the CCMR Report; however, this comment will limit its focus to those recommendations concerning regulatory reform.

The recommendations of the CCMR Report for regulatory reform focus on four areas: improved cost/benefit analysis of regulation, a shift to more principles-based form of rules, adopting a more prudential supervisory regime, and greater domestic and international cooperation among regulators. A model of regulatory framework frequently discussed in the report is the United Kingdom’s Financial Services Authority (FSA), which is already premised on a principles-based approach.

The CCMR recommends that the SEC and self-regulatory organizations (SROs) focus much more energy on evaluating the costs and benefits associated with proposed rules, and in

171 Id. at 4-5.
172 Other recommendations discussed in the CCMR Report deal with (1) reforming public and private sector enforcement by allowing companies to adopt limits to their exposure to class actions, reserving criminal prosecutions for truly exceptional cases, reducing the present level of auditor liability, recognizing the practical difficulties in the present requirements facing outside directors acting in good faith reliance on prepared information, and allowing greater indemnification of those outside directors acting in good faith; (2) improving shareholder rights, especially in the areas of their right to vote on takeover defenses and the adoption of alternative dispute resolution procedures; and (3) revising implementation of section 404 of the Sarbanes-Oxley Act through greater clarity in defining “material weakness,” better regulatory guidance, and revised requirements for small companies and foreign companies. See id at 12-21 (citing to executive summary, and also discussed at greater length in sections III, IV and V). It should also be noted that the regulatory reforms of the CCMR report are directed specifically at securities regulation, but many of the recommendations could be applied to the much broader issue of financial services market regulation as a whole (that being the focus of this comment).
173 Id. at 59.
reassessing the practicality of existing rules.\textsuperscript{174} The CCMR offers four ways to implement a greater focus on cost/benefit analysis, ranging from legislative enactment of such a requirement to voluntary adoption of such analysis by the regulators.\textsuperscript{175} By following a cost/benefit approach to assessing regulation, regulators would promote greater efficiency and reduce unnecessary costs to the market.

The CCMR also suggests a shift to a more principles-based form of regulation, which would involve reassessing and reformulating the existing rules into a much simpler set, or sets, of guiding principles based on the differing needs of the market:

Sensible principles of good regulation, including efficiency, economy, and proportionality, suggest that rules reflect the differing needs for protection, both in types and amount, of various investors whose knowledge, sophistication, and understanding varies. Therefore, these same principles would dictate different, at least in part, rulebooks for dealings with wholesale and retail investors. No doubt, the proper application of a cost-benefit analysis would lead to the same conclusion.\textsuperscript{176}

The CCMR also contends that the present “high-profile” strategy of securities regulators, which focuses on compliance with specific rules and broad publicity of enforcement actions, is at odds with the reforms contemplated in the report.\textsuperscript{177} The CCMR recommends a shift to a more open dialogue between the regulators and the regulated, and a prudential approach that concentrates on “safety and soundness” of the financial system, more in line with the approach of banking regulators.\textsuperscript{178} This approach would engender more willingness of the regulated entities to bring their problems to the regulators rather than hiding those problems from fear of public

\textsuperscript{174} Id. at 60-63.
\textsuperscript{175} Id.
\textsuperscript{176} Id. at 65.
\textsuperscript{177} Id. at 66.
\textsuperscript{178} Id.
disciplinary action.\textsuperscript{179}

A corollary to this issue is the proposal by the CCMR that regulators refrain from using enforcement action to “refashion existing rules.”\textsuperscript{180} This \textit{ad hoc} approach to rulemaking and enforcement “has the effect of engendering greater uncertainty in the marketplace” and reducing the willingness of regulated entities to communicate their regulatory concerns to the regulating agencies.\textsuperscript{181}

The final recommended course of action by the CCMR Report is to increase cooperation and dialogue among federal regulators, as well as between federal and state regulators, to reduce the friction and “duplicate[ive] structure that leads to both inconsistent rules and a waste of resources.”\textsuperscript{182} This call for domestic coordination and the recognition of the need for greater international regulatory cooperation can best be achieved by the shift to a more harmonized principles-based form of regulation rather than trying to synchronize numerous extensive sets of prescriptive rules.\textsuperscript{183}

The recommendations made by the CCMR are all interrelated: cost/benefit analysis would be a fundamental precept in a shift to a more principles-based approach to regulation, which in turn would stimulate a more prudential regulatory approach leading to greater dialogue between the regulators and regulated. And a move to a more principles-based regulatory approach would make it easier to harmonize domestic and international regulation.

Another recent report, the McKinsey Report, was commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer (D., N.Y.) to evaluate the

\textsuperscript{179} \textit{Id.}
\textsuperscript{180} \textit{Id.}
\textsuperscript{181} \textit{Id.} at 67.
\textsuperscript{182} \textit{Id.} at 68.
\textsuperscript{183} \textit{Id.} at 68-70.
competitiveness of U.S. financial services markets.\textsuperscript{184} The McKinsey Report makes recommendations for broad reform to the regulation of financial services industry in the U.S., and does not restrict its discussion to the securities markets (as did the CCMR Report).

The McKinsey Report makes eight recommendations to increase the U.S.’ competitiveness in the modern global marketplace.\textsuperscript{185} These recommendations consist of (1) providing clearer guidance for implementing the Sarbanes-Oxley Act; (2) implementing securities litigation reform; (3) developing a shared vision for financial services and a set of supporting regulatory principles; (4) easing restrictions facing skilled professional workers (particularly immigration policies); (5) recognizing the International Financial Reporting Standards without reconciliation with U.S. GAAP., and eventual convergence to a harmonized set of accounting standards; (6) rethinking the U.S. modifications to the Basel II Capital Accord; (7) forming a National Commission on Financial Market Competitiveness to guide the future of the U.S. financial markets; and (8) modernizing the charters of the financial services industry regulators, holding company models and operating structures.\textsuperscript{186}

These recommendations echo many of the reforms suggested by the CCMR Report, but also add some other proposals such as relaxing the immigration restrictions for skilled

\textsuperscript{184} \textit{McKinsey \\ & Co., Sustaining N.Y.'s and the U.S.' Global Financial Services Leadership} (Jan. 2007) [hereinafter McKinsey Report]. “Mayor Bloomberg and Senator Schumer asked McKinsey & Company to work with the New York City Economic Development Corporation (NYCEDC) to develop a better understanding of the contribution that strong, innovative financial markets can make to a vibrant economy. . . . To bring a fresh perspective to this topic, a McKinsey team personally interviewed more than 50 financial services industry CEOs and business leaders. The team also captured the views of more than 30 other leading financial services CEOs through a survey and those of more than 275 additional global financial services senior executives through a separate on-line survey.” \textit{See} Aaron Lucchetti, \textit{Identity Crisis for New York?}, \textit{N.Y. Times}, Jan. 22, 2007, at C3 (discussing the release of the McKinsey Report).

\textsuperscript{185} McKinsey Report, \textit{supra} note 184, at 97-118. The McKinsey report also has a thorough discussion of U.S. competitiveness in today's markets (Section II), and some specific suggestions for increasing New York's competitiveness (Section IV (B)).

\textsuperscript{186} \textit{Id.} These eight recommendations are divided into three categories: critically important, near term national priorities ((1)-(3)); initiatives to level the playing field ((4)-(6); and important longer-term national issues (7)-(8)).
professional workers, rethinking the U.S. modifications to the Basel II Capital Accords, and forming a National Commission on Financial Market Competitiveness. This comment will again focus on the regulatory reforms discussed in the McKinsey Report, as was the focus on the CCMR Report.

The McKinsey Report states that “London already enjoys clear leadership in the fast-growing and innovative over-the-counter (OTC) derivatives market.” The McKinsey Report attributes this success in attracting derivatives activity to London’s overall regulatory environment, which is perceived by business leaders to be superior to that in the U.S. and because the business community feels that U.K. regulators are more responsive and efficient. The increasing pace of innovation and new product development has put an increasing emphasis on regulatory responsiveness and flexibility:

An increasingly heavy regulatory burden and a complex, cumbersome regulatory structure with overlaps at the state and national levels is causing an increasing number of businesses to conduct more and more transactions outside the country. For many executives, London has a better regulatory model: it is easier to conduct business there, there is a more open dialogue with practitioners, and the market benefits from high-level, principles-based standards set by a single regulator for all financial markets.

187 The efforts of the Basel Committee on Banking Supervision to revise the standards governing the capital adequacy of internationally active banks achieved a critical milestone in the publication of an agreed text in June 2004. The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. In addition, the Basel II Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop or improve their ability to manage those risks. As a result, it is intended to be more flexible and better able to evolve with advances in markets and risk management practices. BANK FOR INT’L SETTLEMENTS, BASEL II, http://www.bis.org/publ/bcbsca.htm (last visited Feb. 11, 2007).

188 Specifically Section II (C) Competition intensifying in two key markets: derivatives and debt and Section III (B) Recent US regulatory trends damaging competitiveness and the corresponding recommendations of the McKinsey Report, supra note 184.

189 McKinsey Report, supra note 184, at 54.

190 Id. at 78.

191 Id. at 80.
The McKinsey Report highlighted three themes to help explain the growing differences between U.S. and U.K. regulatory environments: “the regulatory structure, the regulatory and supervisory approach and the regulatory enforcement.”\textsuperscript{192} The Report discusses the fragmented, and what has been characterized elsewhere as “dysfunctional,”\textsuperscript{193} structure of U.S. regulation of financial markets, finding that it is perceived by many as unresponsive, and consequently stifling of innovation.\textsuperscript{194}

The McKinsey Report also criticized the U.S. regulatory approach, in contrast to the FSA principles-based approach, as relying too much on rules and compliance, which ignores the materiality of risk in favor of imposing legislatively mandated regulations, many of which date back decades and have failed to keep pace with the times.\textsuperscript{195} This is another feature that could be avoided by a shift to a principles-based system of regulation.

The McKinsey Report found that while the FSA was perceived as open to discussing potential problems without fear of reprisal, “[t]he multiple US regulators and enforcers, by contrast, play a different game entirely,”\textsuperscript{196} However, the McKinsey Report does specifically mention and commend the recent credit derivatives industry initiative as a positive example of collaborative action to address and resolve issues jointly.\textsuperscript{197}

Another intriguing recommendation of the McKinsey Report was for a new commission to assess the long-term, structural issues affecting the health, competitiveness and leadership of U.S. financial markets, the National Commission on Financial Market Competitiveness.\textsuperscript{198} This Commission should evaluate the possibility of a single regulator for all financial markets, which

\begin{thebibliography}{198}
\bibitem{192} Id. at 81.
\bibitem{193} See CCMR Report, \textit{supra} note 159, at 67.
\bibitem{194} Id. at 81-82.
\bibitem{195} Id. at 83-84.
\bibitem{196} Id. at 84.
\bibitem{197} Id.
\bibitem{198} Id. at 113-15.
\end{thebibliography}
governed by a principles-based regulatory framework, would have superior flexibility and ability to deal with emerging issues in the markets.\textsuperscript{199}

While the McKinsey Report stopped short of calling for a wholesale replacement of the current rules-based regulatory system with a principles-based approach, it did recognize the need to develop a “clearly articulated vision, strategy and mandate” to bring greater flexibility and predictability to U.S. regulation.\textsuperscript{200} The shift in regulatory approach should emphasize collaboration, dialogue between regulators and market participants, and emphasis on empirical effectiveness, all of which could be furthered through implementing a common set of principles for the regulation of all financial institutions in the U.S.\textsuperscript{201} The Report also stated:

\begin{quote}
In a rapidly changing and increasingly global financial marketplace, the private sector can provide information and insights on market trends, customer needs, and market impact that are valuable contributions to the decision-making process at both the local and national levels. The [National Commission on Financial Market Competitiveness] should therefore encourage ways to enhance thoughtful private sector input to any policy or regulatory decision as a means of helping to ensure better implementation and execution over time.\textsuperscript{202}
\end{quote}

Taken together, the CCMR Report and the McKinsey Report illustrate important themes in the recent evaluation of U.S. regulation. Many are in favor of a shift toward a principles-based approach. There is a wide consensus that regulators should place greater emphasis and focus on cost/benefit analysis to determine the practical efficiency of proposed regulation. There is recognition that markets are changing, consolidating and integrating across industries that are currently compartmentalized by the U.S. regulatory framework. The alternative model of U.S. financial services regulation proposed in the next section will incorporate all of these ideals

\begin{flushright}
\textsuperscript{199} \textit{Id.} at 114.  \\
\textsuperscript{200} \textit{Id.}  \\
\textsuperscript{201} \textit{Id.} at 22.  \\
\textsuperscript{202} \textit{Id.} at 115. For a similar view on the benefits of private sector influence in regulation see Donaldson & Pitt, \textit{infra} note 218, at A7 (stating that “[w]ith SROs and the industry taking the lead, the need for a governmental solution is eliminated, and that’s always a preferable course”).
\end{flushright}
around the central tenet of transferring market control to the collective control of the participants, as was done in the Major Dealer initiative in the credit derivatives market.

**PART VI: A Model for Future Regulation?**

The progress made by the Major Dealers in the credit derivatives markets is an example of how market participants can come together and make a collective effort to improve the very market upon which they all depend. Their economic livelihood is inextricably intertwined with the efficient operation of the markets in which they trade. The actual market participants are the entities best situated to come up with the most practical and efficient solutions for the problems in the marketplace because they are the ones who deal with those problems on a day-to-day basis and they are the ones who will profit the most from an increasingly efficient market. They will be motivated to move quickly and have the first-hand knowledge necessary to formulate and adapt regulation and market practices to ensure that regulation does not become a suffocating or stifling force, but breeds innovation and encourages ingenuity.

There has been widespread approval of the Major Dealer initiative. One regulator stated that it could serve as “sort of a model for regulators for collective action to address other problems that might arise.” The Major Dealer initiative was also cited approvingly in the McKinsey Report; Assistant Secretary of the Treasury Emil Henry, Jr., remarked that the developments in the credit derivatives market were “proof of self-correcting free market capitalism at its best;” Gerald Corrigan (organizer of the CRMPG initiative) stated that he was encouraged by the progress made by the Major Dealers and that “[t]he model of private and

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public sector cooperation and collective action is functioning very well and is likely to have broader applications.”

However, former NY Fed President, Timothy Geithner (who originally called for and hosted the meetings of the Major Dealers), said “he believes that the credit derivatives example is a special case – where the participants had an overwhelming interest in making progress – rather than a potential model.” This statement seems contrary to the recent action by the NY Fed in meeting with senior managers and compliance officers from 22 primary dealers to discuss ways to strengthen the integrity of the U.S. Treasury market by strengthening market practices, so as to maintain its status as the deepest and most liquid sovereign debt market in the world.

As well as the NY Fed’s instigation of an initiative in the equity derivatives markets that is almost identical to the Major Dealer initiative in the credit derivatives market.

Also, contrary to Mr. Geithner’s assertion, it would seem that participants in all markets would have an “overwhelming interest in making progress” toward more efficient regulation.

All participants are impaired by inefficient regulation, which increases costs, wastes time and constrains innovation. Such inefficiency cuts into profits. Wouldn’t participants in all markets share the underlying motivation of wanting to increase the efficiency of the regulations that

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205 Banks Chart significant Progress Toward Key Risk Mgmt. Goals, 38 Sec. Reg. & L. Rep (BNA) [No. 10, at 366] (Mar. 6, 2006) (quoting Corrigan, and discussing the progress made in the credit derivatives markets, as well as continuing challenges).


208 See supra note 133 (discussing the initiative in the equity derivatives market).

209 See supra note 206 and accompanying text. Also, if Mr. Geithner’s remarks were contemplating the fact that the Major Dealers had an increased motivation for self-correcting the problems in the industry in order to remain free of external regulation, such motivation would be inherent in all markets if they were given the opportunity to self-regulate as in the model proposed in this comment. In fact, Mr. Geithner was also quoted as saying, “[w]e need to be able to move more quickly than we have in the past; we need to be prepared to work with the market and use the market to find sensible solutions – and we need to have a more integrated framework . . . .” 38 Sec. Reg. & L. Rep. (BNA) [No. 47, at 2005], supra note 203. These remarks coincide perfectly with the model of regulation advocated in this comment and lend even more support for using the Major Dealer initiative as a model for future regulation.
dictate the extent of their freedom to pursue profit?

The theoretical regulatory model advocated by this comment is that of a single market regulator which oversees all markets in financial services, but delegates to those market participants the authority to formulate the rules by which each market will operate. This is an extension and adaptation of the SRO model relied upon by the securities and commodities markets in which the authority to develop specific rules to govern distinct segments of the market is allocated to the exchanges, thereby shifting some of the regulatory burden off of the governmental agency and placing it on a group that has the benefit of more direct participation in the market. This comment suggests taking the present SRO ideal, and extending it even further. Place the responsibility for designing best practices and industry standards in the hands of those best suited and most plugged-in to the needs of the markets: the actual market participants, not the exchanges.

The government regulator would be an oversight and enforcement body that guides the markets by a simple, but comprehensive set of general principles that each market would have to abide. It would be the enforcement body of this model, ensuring compliance not only with the

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210 This author is not naïve enough to believe that such dramatic changes to the U.S. regulatory structure will overcome the practical hurdles to become reality, but the principles of consolidation of oversight and delegation of rulemaking to market participants are ideals that should be furthered at every given chance to increase the efficiency of regulation and thereby enhance U.S. competitiveness.

211 For a discussion of the development of the SRO regulatory model in the securities and commodities and futures markets, see Markham, supra note 18, at 325-56 and Keaveny, supra note 16, at 1423-38.

212 The market participants would have the most powerful motivation to ensure efficient regulation: they would all benefit from eliminating redundancy; they have the firsthand knowledge to formulate regulations that ensure competitiveness; and their daily experience in the markets will allow them to constantly assess and evaluate the current regulations, and make any necessary changes.

213 It should be noted that there is potential for abuse by a single market regulator, as recognized by Markham, supra note 18, at 405:

A single regulator may also seek to expand its powers after a scandal. A single regulator will also undoubtedly use bad judgment in times of crisis. A single regulator could also stifle competition, over-regulate, and cause a loss of competitive position in international markets. It could even try to . . . manage the economy by bureaucratic fiat.

Professor Markham’s point is well taken, and correct. Without competing regulatory bodies, there is less of a check on the ability of a regulator to overreach its authority. However, many of these concerns would be offset by the use of the extended SRO model advocated in this comment, which would dilute the control of the government regulator
general principles that it will promulgate, but also with the more specific standards adopted by each market. It would also provide guidance and coordination by bringing to the attention of each market any problems or issues that it recognizes. But it would then delegate the resolution of those issues to the actual market participants, who would be free to adopt the most efficient solutions (as long as those solutions are in accordance with the general principles of the government regulator).

Although still a far cry from a single consolidated government regulator, the U.S. regulatory agencies apparently recognize the benefits of the consolidated approach to regulation advocated by this comment. The efforts of the different agencies who sat in on the Major Dealer meetings are one example, as well as the collective effort of the President’s Working Group on Financial Markets, “which consists of the Secretary of the Treasury and Chairmen of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, [and] has creatively examined system-wide issues across the legalistic and jurisdictional divides that normally separate one regulator's thinking from another's.”

There would be two ways to coordinate the collaboration of market participants: first, through working groups, committees and conferences arranged by the government regulator; or alternatively, through similar efforts spearheaded by membership organizations. In the first version, the government regulator would schedule periodic conferences and meetings of market participants to allow them to review existing practices and create new ones to address issues within each market. This would be directly based on the prototype of the Major Dealer initiative to a role of guidance and enforcement. Also, the government regulator would answer to Congress, and through lobbying efforts, the financial services industries would be able to exercise a modicum of control over abuse of power by the government regulator. It should further be noted that Professor Markham did not come to the conclusion that a single regulator would be not be the best approach, but rather stated that “a unified regulator seems to be a sound idea,” while recognizing both the strengths and weaknesses inherent in such an approach. Id. at 410.

in the credit derivatives market. In the second version, market participants could act collectively through a membership organization, such as the ISDA in the OTC derivatives market or the proposed NASD-NYSE single-SRO for the securities industry, to address those same issues.\(^\text{215}\) This second version is more of an extension of the SRO model now used in the securities and futures markets.\(^\text{216}\)

In both versions, the market participants would collaborate to solve issues in their market by establishing practices by which they would all be bound. The government regulator would oversee the practices and rules in each market to ensure conformity to the government regulator’s principles, and compliance by all market participants. The more frequent the meetings of the market participants, the greater flexibility and responsiveness of regulation would be to actual market conditions.

The recent approval of the NASD-NYSE merger into a single self-regulatory organization is a significant step toward the consolidation and increased efficiency that is essential to U.S. regulatory reform.\(^\text{217}\) This merger has been praised and approved as a plan to eliminate complexity and confusion, as well as consolidating the expertise of market

\(^{215}\) A similar framework is developing in the securities industry with the merger of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) member regulation functions into a single self-regulatory organization. News Release, NASD, NASD Member Firms Embrace Streamlined, More Efficient Regulation (Jan. 21, 2007), available at http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_018334 (discussing the merger between the two regulatory organizations into a single SRO which will “create a single regulator for the country’s nearly 5,100 broker-dealers, eliminating overlapping regulation and reducing costs to the industry.”)

\(^{216}\) By placing the responsibility for regulating each market in the hands of the market participants through working groups organized by the governmental regulator or through non-profit membership organizations adaptation of the current SRO model, another controversy would be settled, i.e. the unrest caused by the demutualization of many exchanges. Many feel that by making exchanges a for profit enterprise, there will be increased incentive for those exchanges to become lax in their regulatory capacity and even inherent conflict between the pursuit of profit and the “separate” regulatory function of ensuring compliance by its members. For a discussion of the demutualization concerns, see Caroline Bradley, \textit{Demutualization of Financial Exchanges: Business as Usual?}, 21 \textit{Nw. J. INT’L L.} \\ & BUS. 657 (2001); Keaveny, \textit{supra} note 168, at 1438-1450; see also Aaron Lucchetti, Alistair MacDonald & Kara Scannell, \textit{NYSE, Euronext Set Plan to Form Markets Giant – Landmark $20 Billion Deal by U.S., Europe Exchanges Faces Oversight Questions}, \textit{Wall St. J.}, June 2, 2006, at A1.

The benefits of the merger would be increased efficiency and reduced cost, but this approach would still be applying externally created rules and regulation on the market. This merger also fits nicely into the proposed framework for a new regulatory model proposed in this comment as a preliminary step in moving toward a more consolidated regulatory environment, but falls short of placing the control of the market in the hands of the actual participants.

The market participants would be motivated to approach regulation from a cost/benefit approach, thereby ensuring efficiency and hopefully fostering an environment where innovation and adaptation would be nurtured and encouraged through firsthand experience in determining the effectiveness of regulation. The ideals of investor protection and market integrity should not be discarded or ignored, but merely applied in the most effective manner of implementation to allow the U.S. markets to remain competitive.

Potential Concerns

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218 William H. Donaldson & Harvey L. Pitt, Outdated and Inefficient, WALL ST. J., Jan. 6, 2007, at A7 (both authors are former chairmen of the SEC) (criticizing the current state of securities regulation as “redundant and inefficient and in that context doesn’t benefit either investors or the industry,” and calling the merger “the first significant change in the self-regulatory regime in this country in more than 70 years”); see Christopher Cox, Chairman, SEC, More Efficient and Effective Regulation in the Era of Global Consolidation of Markets, Nov. 10, 2006, available at http://sec.gov/news/speech/2006/spch111006cc.htm (stating “[a]s Chairman of the Securities and Exchange Commission, I strongly support these efforts, which are currently well underway, to fold the member regulation functions of both the NASD and the NYSE into one regulatory body. I’m firmly convinced that, done properly, this can make our self regulatory system more efficient and more robust from an investor protection standpoint.”). It should be noted that not all of the comments regarding the planned merger have been positive. Most of the criticism focuses on the perceived decrease in investor protection, subjugation of smaller market participant interests and increased industry influence as opposed to investor protection. William F. Glavin, Sec. of the Cmnwlth. of Mass. (Boston), Letter to the Editor, Multiple Regulators Vital to U.S. Securities Markets, WALL ST. J., Dec. 11, 2006, at A19 (stating that “[i]f NYSE regulation is merged into the NASD, there will be one less decision maker evaluating the conduct of market participants.”); see also Randall Smith, NASD’s Chief Fights for United Regulators, WALL ST. J., Dec. 15, 2006, at C1 (presenting a brief balanced review the issues facing the planned merger).

219 The market participants would have somewhat of a voice in the rules and practice promulgated by the single regulator, with 10 of the 23 seats on the board of directors reserved for industry representation. Smith, supra note 218, at C1. Having a minority representation on the board of directors is a far cry from the direct industry initiative of designing the rules for the markets in which they operate as advocated by this comment and exemplified in the Major Dealer initiative in the credit derivatives market.

220 While this merger and consolidation of market SRO regulation has been applauded, there are some underlying concerns regarding the demutualization of exchanges that also serve a regulatory function, as discussed supra at note 216.
The model of regulation proposed in this comment does raise some potential concerns, such as the opportunity for collusion, the possibility of exclusion and subrogation of the interests of smaller participants, lessened investor protection, as well as a host of practical implementation impediments. This comment will address and offer responses to curb some of the disquiet concerning the first three of these issues, but fully recognizes the practical concerns and impediments confronting a model of regulation calling for an extensive revamp of the entire U.S. system of regulation. Such obstacles are the purview of policymakers and lobbyists, and deal with issues well beyond the abilities of this author to overcome. However, barriers which focus not on the merits of such change, but on the bureaucratic difficulties of implementation should not dictate the course of progress.

Some people might argue that placing the regulation of financial markets in the hands of the actual market participants would be like letting the foxes guard the henhouse. While there is always potential for abuse by some in any system of regulation, this author does not believe that the proposed model of collective control by the market would inherently engender collusion or abuse. In a collaborative regulatory environment, individual economic concerns would cause the group to deny any individual a competitive advantage. The market participants acting as a group would operate as a natural check and balance on any individual attempt to manipulate the system to its own advantage. Further, all regulation would be monitored by the government regulator to assure compliance with general principles, which would have an intrinsic “policing effect” on any widespread collusion. The market participants would be given the opportunity to create the most efficient and adaptable regulatory environment, but that regulation would still have to conform to the ideals of integrity, transparency and fairness as mandated by the overseeing government regulator.
The concerns over lessened investor protection are answerable in the same vein. The government regulator would not be abandoning its role of ensuring integrity and investor protection. This comment does not purport to lessen or change such ideals, just to allow the implementation of such principles to be decided in the most efficient manner, to ensure the competitiveness of U.S. markets.

Concern over exclusion and subjugation of smaller market participant interests could be addressed by mandatory representation of smaller interests in any policy making committee. A “one firm, one vote” policy would ensure that all market participants would have an equal voice in determining market practices and standards. Policies would have to be enacted either at the level of the government regulator’s principles or at the membership organization level to strike the right balance between the representation of interests of small and large players.

**Conclusion**

The regulatory model advocated in this comment envisions markets that are regulated by collective action of market participants through either groups organized by a government regulator or through membership organizations, all of which is overseen by a single government regulator that guides the markets (through open dialogue and a set of simple principles) and ensures compliance through enforcement of not only its core principles, but also with the rules promulgated by the individual markets.

The example of the Major Dealer initiative in the credit derivatives markets is an archetype for collective action by market participants under the guidance of regulators who allow self-correction of industry-wide problems and self-determination of best practices by those best

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221 See Smith, supra note 218, at C1 (describing one reason for opposition to the NASD-NYSE merger as “[NASD] dissidents are worried they will lose their voice because it will end the NASD’s current ‘one firm, one vote’ policy, which favors small firms . . .”). Such a policy carries with it the reciprocal concern of excluding the interests of the larger firms by diluting their influence in the collaborative process with copious representation of smaller firms.
situated and motivated to deal with those issues. Further, the single government regulator approach of this model finds support in the collaborative efforts of the regulators who take part in the President’s Working Group on Financial Markets, which recognizes the need to approach issues from a consolidated rather than fragmented vantage, as well as recent reports that call for reform and consolidation of the U.S. regulatory structure. Together, these two components will further the efficiency of market regulation and U.S. competitiveness, which should be two of the goals for any future model of U.S. regulation that is adopted.