OTC Derivatives Trading Under the Financial Reform Bill: Is It Tough Enough?

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ABSTRACT

Both the U.S. House of Representatives and the U.S. Senate have drafted financial reform legislation prompted by the financial market failings the country experienced in 2008. Both versions provide for comprehensive regulation of the OTC derivatives products, which were used extensively by those financial institutions that lost millions of dollars from investments in mortgage securities to insure against subprime mortgage defaults. This paper discusses the efficiency of proposed Congressional legislation to regulate the Over-the-Counter (OTC) derivatives market in light of the provision in the legislation that effectively exempts customized OTC derivatives contracts from clearing requirements and exchange trading. The exemption allows OTC derivatives dealers trading customized contracts to continue trading in the same opaque markets in which they engaged in rent seeking behavior that almost led to the collapse of the financial markets. The manuscript discusses why Congress has proposed these exemptions, why the exemption creates economic inefficiencies, and calls for Congress to devise a definition for customized OTC derivatives contracts to narrow the definition of what constitutes a customized trade to ensure that OTC derivatives dealers are not allowed to intentionally craft their OTC derivatives contract to avoid clearing and exchange trading requirements.

I. Introduction

In December 2009, the U.S. House of Representatives passed The Wall Street Reform Act whose stated purpose is to provide “financial regulatory reform, to protect consumers and investors and to regulate the over-the-counter derivatives markets.”

The proposed legislation was prompted by numerous calls for more stringent regulation

1 The Wall Street Reform Act, H.R. 4173, 111th Cong. § 3101 (2009) (hereinafter The Wall Street Reform Act)
of the financial markets after the 2008 market’s financial collapse. The U.S. Senate recently issued a discussion draft entitled *Restoring American Financial Stability Act of 2009*. The regulatory framework for the OTC derivative market in its discussion draft is similar the framework contained in the House bill.

A. Proposed Legislation

Both the Senate Draft and the House bill contain comprehensive regulation of the OTC derivatives markets. Initially, Congress wanted to mandate clearing requirements and exchange trading for all OTC derivatives to ensure the efficiency of the OTC market in much the same way that public trading of commodities and securities has ensured the efficiency of those respective markets. As drafting process progressed however, Congress bowed to pressure by special interest groups that argued against mandating exchange trading and clearing requirements for


customized derivative contracts. Many OTC derivatives contracts are customized with their terms tailored by end-users to manage specific risk within their financial portfolio.

While exchange trading and clearing is suitable for OTC derivatives contracts containing standardized terms, neither is very workable for OTC contracts, which contain individualized terms customized to manage specific risks of end-users.

Congress could have drafted legislation that rendered such contracts illegal because of the systemic risk they pose, yet doing so would be against our economic interest and against that of the global economy. Customized derivatives are utilized by

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7  Testimony of Gary Gensler, Chairman of the Commodities Futures Trading Commission, Before the Senate Committee on Agriculture, Nutrition and Forestry, June 4, 2009 (noting that those “tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated.”) (hereinafter, Gensler Testimony)
“more than 90% of Fortune 500 companies” on a daily basis. Over the past thirty years, OTC derivatives contracts have become an essential and integral part of our domestic as well as the global market. They have provided tremendous liquidity to the capital and investment markets from which all sectors of our economy have benefited. OTC derivatives are however volatile instruments whose misuse, as evidenced by the country’s most recent financial fiasco, can have devastating and reverberating effects on an economy. Regulation is necessary to protect against this type of systemic market failure.

To address the competing economic and regulatory interests surrounding OTC derivatives products, Congress has proposed legislation that only requires exchange trading for OTC derivatives contracts that must be cleared through clearinghouses. It excludes customized OTC derivatives contracts from clearing and exchange trading requirements which effectively allows dealers to continue trading such contracts in

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8 Point of View, supra note 6.
9 Wall Street Reform Act, supra note 1; see also Senate Committee Print, supra note 3.
opaque markets that utilize voice brokering as an alternative to exchange trading.  

This paper examines the economic efficiency and efficacy of the proposed legislation to prevent systemic market failure in light its treatment of customized OTC derivatives contracts.

II. Systemic Risk Posed by OTC Derivates Trading

OTC derivatives trades were largely exempt from state and federal regulation in 2000 by Congress’ enactment of the Commodities Futures Modernization Act of 2000.  

Congress exempted OTC derivatives from regulation because it was concerned that regulation of the market would cause OTC derivatives business to migrate to foreign markets with less regulation causing the U.S. to lose their competitive position.  

Yet, many have pointed to Congress’ decision in 2000 to exempt such transactions from regulation as a significant factor contributing to the Great Recession of 2008, the


 Id.
country’s worst financial crisis since the Depression era. Most notably, the voluminous trades in credit default swaps, a form of OTC credit derivatives utilized by financial institutions as insurance against subprime mortgage losses, have been viewed by many as instrumental in precipitating the systemic market failure that created negative externalities in the form of constricted credit and massive federal bailouts.

A. The Lessons of AIG

American International Group Financial Products (AFP), a subsidiary of American Insurance Group (AIG), the world’s largest insurance company, is evidence of how trading in credit default swaps contributed to the threat of systemic market failure.

AFP reportedly sold $440 billion credit default swaps to banks and other financial institutions.

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14 Mooray Choudry, In Introduction to Credit Derivatives 11 (2004). A credit default is a type of OTC credit derivative that parties use to hedge against loss related to credit obligations such as loans or bonds. Id The most common form of a credit default swap is “vanilla” credit default swap, which allows a party holding a credit obligation referred to as the “protection buyer” to purchase a credit default swap to shift the risk associated with the credit obligation to a “protection seller,” a party willing to assume the risk of loss.

15 David Wessel, In Fed We Trust 194 (2009) (author noting that in March 2009, Bernanke told a congressional committee that “the Fed ‘really had no choice’ but to sink billions into the company (AIG) to try to stabilize it because the failure of what had become such a major financial operation in the midst of a crisis could be ‘disastrous for the economy.’ ”) (hereinafter Wessel, In the Fed We Trust).
institutions as insurance against mortgage securities defaults. However, it did not have sufficient capital to honor credit default swap contracts once banks’ debt securities collateralized by subprime mortgages defaulted. It acted like a large hedge fund making huge bets through OTC derivatives contracts that resulted in enormous losses due to subprime mortgage defaults. AIG had sold some form of financial insurance to almost “every major financial institution in the world.” Its financial downfall would have crippled the financial stability of the global economy.

To prevent systemic market failure on a global level, the government to date has provided AIG over a $180 billion, sixty-two billion of which amounted to a “secret ‘backdoor bailout’ of banks who were made whole” on credit default swaps they had


Eric Dinallo, What I Learned at the AIG Meltdown, Wall Street Journal Opinion A17, February 3, 2010 (hereinafter Dinallo, What I Learned at the AIG Meltdown) Eric Dinallo was the former superintendent of insurance for New York State. Id. See also Wessel, In Fed We Trust, supra note 16, at 194 (author noting that Bernanke to a congressional committee that, “AIG came to us (the Federal Reserve) on the brink of default.”)

Wessel, In Fed We Trust, supra note 15 at 192 (author noting that “nearly every major financial institution in the world had bought financial insurance of some sort or placed huge bets with AIG.”)

Id.

Id. at 194.
with AIG. The payoffs were coined “bailouts” because the banks that received the money were on the brink of financial collapse themselves in large part due to hundreds of millions of dollars of toxic mortgage securities they held. The banks had purchased credit default swap insurance from AIG to protect against mortgage securities defaults. They needed the payoff from AIG to cover their losses from mortgage securities as credit markets tightened.

III. The Efficiency of the Proposed Legislation

The efficiency of Congress’ legislation will be determined by its ability to protect against the type of systemic market failure that regulators feared when they were confronted with the pending financial collapse of AIG. In other words, the efficiency of the legislation turns on whether the prescribed rules therein will render market


22 Carney, How The Federal Reserve Bungled The AIG Rescue, supra note 22 (reporting that the Fed paid 100 cents on the dollar payment to banks with credit default contracts with AIG because it “feared making banks take a haircut on the AIG swaps would leave them (banks) with insufficient capital.”)

23 Wessel, In Fed We Trust, supra note 15, at 190; see also Davidson, How AIG Fell Apart supra note 17.
participants capable of absorbing their own losses rather than externalizing them? To meet this challenge, the House bill and the Senate’s Discussion Draft adopt clearinghouse, margin and capital requirements of the type that are imposed on market participants trading in the securities and commodities market. Such requirements have brought finality to securities and commodities trades ensuring each the efficiency of the respective markets.

A. The Role of Clearing and Margin Requirements

Clearinghouses insulate trading parties from each other by serving as a buyer to a seller an OTC derivatives trade and as a seller to the buyer of the trade.

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24 Gensler Testimony, supra note 7 (Chairman Gensler noting “(e)xchange trading and clearing are the two key components of well-functioning markets” and that “the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction.” Both the bill and the discussion draft define OTC derivatives contracts as swaps, and the term “swap” is broadly defined to encompass all types of OTC derivatives contracts. The Wall Street Reform Act, supra note 1 and Senate Committee Print, supra note 3. The Commodities Futures Trading Commission is granted jurisdiction over swap transactions unless those swaps are security-based with renders them subject to the jurisdiction of the Securities Exchange Commission. Excepted from the jurisdiction of the SEC and CFTC are those swaps traded by entities regulated by a prudential regulator. Id.

25 Gensler, supra note 7. Chairman Gensler testified that subjecting all derivatives dealers to capital and margin requirements would “help prevent the types of systemic risks that AIG created.” Id.

26 Squam Lake Working Group on Financial Regulation, Credit Default Swaps, Clearinghouses, and Exchanges, (Council on Foreign Relations, Working Paper, July 2009). See also E-mail from Leo Wang, Former Assistant Director of Enforcement for Securities and Exchange Commission, to Willa E. Gibson, Professor of Law, University of Akron School of Law (March 10, 2010, 1:07 EST) (on file with author) (hereinafter, Wang E-mail).
requirements function to reduce the amount of risk assumed by parties trading. 27

Sufficient capitalization by OTC derivatives dealers helps prevent the likelihood an
enormous loss of a major market will bankrupt a major dealer whose failure could pose
systemic market failure. If AIG’s Financial Products division had been better capitalized
it could have absorbed the losses from its numerous derivatives trades. 28

Some progress has been made in this area. In March 2009, Intercontinental
Exchange, Inc, a limited purpose trust company, began clearing credit default swaps,
but its clearing is limited to credit default swap indexes and single name credit default
swaps, both of which are largely standardized. 29

Market participants have lobbied against clearing customized contracts because it
would entail greater costs and more involve more work than the clearing of
standardized contracts. 30  Clearinghouses offset trades at the end of each day based

27 Id.

28 See supra Dinallo, What I Learned at the AIG Meltdown, supra note 17.

29 PRNewswire, ice, Ice Trust Successfully Launchers Customer Solution for CDS Clearing:
Over $4.3 Trillion in CDS Cleared to Date Globally, December 14, 2009.

30 Wang E-mail, supra at note 26.
on the trades they receive that day.\textsuperscript{31} For the most part, clearinghouse can offset standardized trades; however, the more individualized the trade the less likely an offsetting transaction to the customized trade will exist.\textsuperscript{32} Absent an offsetting trade, the clearinghouse will have to utilize a computer-based valuation method to determine the value of the trade; and subsequently, it will demand collateral from the dealer based on its estimated value.\textsuperscript{33} Disputes may arise between the clearinghouse and the dealer regarding the value of the trade.\textsuperscript{34} To protect their position, clearinghouses would most likely engage in a conservative assessment of the trade demanding more collateral from the dealer, while the dealer would argue for a more liberal assessment “(to) keep its cost down and (to) provide less collateral.”\textsuperscript{35}

The proposed legislation only requires that OTC derivatives contracts clear through a clearinghouse if a clearinghouse accepts the contract for clearing.  \textsuperscript{36}

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\begin{enumerate}
\setcounter{enumi}{30}
\item Id.
\item Id.
\item Id.
\item Id.
\item Id.
\item Wall Street Reform Act, supra note 1; see also Senate Committee Print, supra note 3.
\end{enumerate}
\end{footnotesize}
Accordingly, it only mandates exchange trading for OTC derivatives contract cleared through a clearinghouse.\textsuperscript{37} This accommodation effectively allows market participants to continue trading customized OTC derivatives in opaque markets without the benefits of price transparency to which standardized OTC contracts are subject. By exempting such contracts from clearing, the legislation creates an exception which dealers may exploit to avoid price transparency and greater disclosure of their OTC derivatives trades.

B. Economic Inefficiencies

Price transparency is however a necessary component for market efficiency. Where price transparency exists spreads between “bid and ask” prices are narrower.\textsuperscript{38} In contrast, spreads are wider in opaque markets allowing dealers to earn high profit margins and avoid the competitive process to the detriment of investors. Supra-

\textsuperscript{37} Id.

\textsuperscript{38} Dawn Kopecki, Matthew Leising and Shannon D. Harrington, Derivatives Lobby Links With New Democrats to Blunt Obama Plan, Bloomberg.com October 9, 2009 (reporting that according to Darrell Duffie, a finance professor at Stanford University, a move to exchange trading that would disclose “real-time prices” could “shrink the amount that dealers make on each trade, known as the spread” resulting in billions of dollars of lost profit.”}
competitive pricing creates an inefficient allocation of resources that requires purchasers of OTC derivatives contracts to pay more than the competitive market price. Supra-competitive pricing also encourages dealers to assume huge bets and to pile on risk. It was that type of trading behavior that led the country to brink of financial collapse in 2008; and the regulatory accommodations in the House bill regarding clearing requirements could render the OTC derivatives market ripe for a repeat performance.

C. Capital and Disclosure Requirements

To protect against systemic market failure the House bill provides that dealers trading OTC derivatives contracts not cleared through a clearinghouse are subject to higher capital standards, while the Senate discussion draft subjects them to “substantially higher capital requirements.” To address the lack of transparency concerning customized contracts, both the House bill and the Senate discussion draft require that certain information concerning customized contracts be reported to a swap repository, a vehicle to be established for the purpose of collecting data.

40 Wall Street Reform Act, supra note 1; see also Senate Committee Print, supra note 3.
concerning OTC derivative contracts for disclosure to regulators. Also, aggregate data on OTC derivatives positions must be disclosed to the public. The higher capital along with margin requirements to which all OTC derivatives trades are subject will help lower the systemic risks associated with trading OTC derivatives contracts in opaque markets. The disclosure of information to swap repositories will allow regulators to monitor trades, but the disclosure of aggregate data to public falls short of the type of price transparency investors enjoy with exchange traded derivatives.

D. An Efficient Solution

An efficient means of lowering the systemic risk associated with trading in customized OTC derivatives contracts is to narrow the definition of what constitutes a customized contract to ensure that dealers do not slightly modify their standardized contracts to render them customized and free from clearing requirements. No clear distinction exists between what constitutes a “standardized” versus “customized” OTC

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41 Id.
42 Id.
43 Gensler, supra note 7.
derivatives contract. There exist a “continuum of contracts types, ranging from some that are highly standardized to those that are tailor-made for a specific transaction with a specific customer.”

Chairman Gensler testifying before the Senate last year expressed concern that dealers and traders might “change a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.”

He proposed a presumption that OTC derivatives contracts accepted by a clearinghouse must be cleared. While the House bill includes that presumption, the Senate discussion draft does not. But, both the House bill and the Senate discussion draft direct and defer to the regulators to determine the “group, category, type or class of swaps” that must be cleared. Presumably, regulators would use this authority to

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44 Wang E-mail, supra note 26.
45 Id.
46 Id.
47 Id.
48 Wall Street Reform, supra note 1.
49 Id.; see also Senate Committee Print, supra note 4.
identify contracts that should be cleared even those clearinghouses at first glance might reject such contracts for clearing.

However, deferring this responsibility to regulators is somewhat problematic.

These same regulators not so long ago failed to detect and to regulate adequately the financial markets during the worst financial crisis in recent history. Congress itself should devise legislation that narrowly defines customized contracts to ensure that only those contracts uniquely individualized are exempt from clearing requirements. Ultimately, the efficiency of financial reform legislation will turn on the extent to which customized derivatives are narrowly defined to exempt from clearing only those OTC derivatives contracts that are uniquely individualized. If the regulators to whom Congress has deferred fail to promulgate specific and stringent rules identifying what constitutes a standardized OTC derivatives contract, the trading of customized contracts will continue to occur in opaque markets where the lure of excessive profit margins will

50 Gensler Testimony, supra note 7. Chairman Gensler in testimony before Congress stated listed the following as examples of objective criteria that regulators should establish to determine whether a swap is standardized: (1) “The volume of transactions in the contract.” (2) “The similarity of the terms in the contract to terms in standardized contracts.” (3) “Whether any differences in terms from a standardized contract are of economic significance; and (4) “The extent to which any of the terms in the contract, including price, are disseminated to third parties.”

Id.
incentivize dealers to engage in the type of rent seeking behavior that almost lead to collapse of the financial markets.