Supplementing Dodd-Frank: An Argument for Further Increasing the Regulation of Credit Default Swaps

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I. INTRODUCTION

Credit Default Swaps have provided protection buyers and protection sellers with customizable financial protection for nearly three decades, all the while operating under a changing regulatory landscape. Credit Default Swaps (CDSs) are highly customizable in nature, allowing a protection buyer to purchase 'protection' from a protection seller in the case of a negative credit event. Then a default payment will be issued, which protects a protection buyer from making a bad investment. CDSs were poorly regulated when they were first introduced over thirty years ago. After the Financial Crisis of 2008, the Dodd-Frank Act was passed and introduced a plethora of new regulations across the entire U.S. financial industry. While Dodd-Frank was a large step in the right direction, it did not completely regulate CDSs. For example, Dodd-Frank did not introduce a protocol for regulating types of CDSs that were not yet in existence when the Act was passed.

This Note examines the weaknesses of the Dodd-Frank Act in terms of regulating CDSs and suggests ways to more comprehensively regulate CDSs and future developments in CDSs without sacrificing the ability to customize CDSs. First, the Note begins with an overview of derivatives, followed by an overview of Credit Default Swaps. Next, this Note examines the regulation—or rather the lack of regulation—of CDSs before the Financial Crisis and new regulations that came into effect as a result of the role of Credit Default Swaps in the Financial Crisis. Then, this Note examines the weaknesses of the Dodd-Frank Act in terms of regulating CDSs, namely the Act's failure to respond to new developments

related to CDSs and its weaknesses related to the establishment of clearinghouses. Lastly, this Note gives recommendations of ways that CDSs can be further regulated without sacrificing their ability to be customized.

II. BACKGROUND

A. Derivatives

A typical definition of a derivative is "a financial instrument whose value derives from that of something else."[1] A financial instrument is simply a contract that lays out a financial agreement between two parties.[2] The value of a derivative is derived from its underlier.[3] An underlier "can or must be sold on or before a future date, at a predetermined (guaranteed) price."[4] Underliers can be any traded item,[5] but some traded items are better underliers than others. A better underlier for a derivative is one that is both fungible—which means an asset can be traded for another asset under the understanding both are equally valuable—and liquid—meaning there are many buyers and sellers of an asset at any given time.[6] Examples of sufficient underliers which are both fungible and liquid include: commodities, foreign exchanges, interest rates, and equities such as stocks.[7]

Derivatives are typically used for hedging or speculation.[8] Hedging and speculating have opposite goals. Hedging involves the mitigation of risk in order to contain any volatility that may occur if the price of a security changes.[9] There is quite a bit of protection against losses with hedging, but gains are also restricted since hedgers take "an opposite position in the market to what they are trying to hedge."[10] Thus, if a negative event happens in the market, that negative event will essentially be canceled out.[11] Speculation involves trying to profit off of an educated guess about market fluctuations.[12] Speculations oftentimes involve purposely taking on additional risk rather than hedging, or decreasing, risk.[13] They involve speed,[14] high risk, and a potentially high return.[15] Speculations are incredibly risky because markets can be volatile and highly unpredictable at times.[16] It is possible to hedge and speculate without using derivatives; however, derivatives have "leverage" in the market.[17] In a derivatives market, this typically means hedgers and

1. MICHAEL DURBIN, ALL ABOUT DERIVATIVES 3 (2d ed. 2010).
2. *Id.*
3. *Id.* at 4.
4. *Id.* at 11.
5. *Id.* at 1.
6. DURBIN, *supra* note 1, at 11.
7. *Id.* at 11–12.
8. *Id.* at 4.
9. Brian Beers, *Hedging vs. Speculation: What's the Difference?*, INVESTOPEDIA (May 4, 2019), https://www.investopedia.com/ask/answers/difference-between-hedging-and-speculation/ [https://perma.cc/7D6H-SD3W].
10. *Id.*
11. *Id.*
12. *Id.*
13. Ignace Claeys, *Speculation: The Devil Burning Down the House? On Derivatives, Gambling, and Public Policy*, *in* FINANCE AND LAW: TWINS IN TROUBLE 89, 98 (Ludo Cornelis ed., 2015).
14. Take high-frequency computer trading as an example.
15. Claeys, *supra* note 13, at 98–99.
16. Beers, *supra* note 9.
17. DURBIN, *supra* note 1, at 5.

speculators can do more with less capital at the outset.[18] For example, buying options in the derivative market can require less capital than buying stocks in the financial market. This allows a speculator to enter the marketplace as a participant with less of a barrier. Similarly, banks can use CDSs to reduce the amount of capital they need to hold in reserve against loans they issued, which leaves money free for banks to use in other ways.[19]

There are four types of derivatives: a forward contract, a futures contract, a swap contract, and an option contract.[20] A forward contract is an agreement to purchase a financial instrument at an agreed upon price on a specified future date.[21] A futures contract is simply a forward contract fulfilled at an exchange, which is where buyers and sellers come together to conduct transactions.[22] A swap contract is an agreement between parties to exchange the cash flows or liabilities from separate financial instruments.[23] An option contract gives one party the right, but not the obligation, to buy or sell a financial instrument at an agreed upon price, on or before a future date.[24] This paper focuses on a type of swap derivative, called a credit default swap.

B. Credit Default Swaps

CDSs are the most popular type of credit derivative.[25] A credit derivative derives its value from an underlier that is the "credit performance of an individual, corporation, government organization, or sovereign entity."[26] A credit default swap involves a party, called the protection buyer and another party, called the protection seller.[27] The protection seller makes an agreement to protect the protection buyer from credit risk by agreeing to pay the protection buyer if a credit event occurs.[28] In exchange, the protection buyer pays premiums to the protection seller.[29] A credit event[30] can be anything the parties agree, including "bankruptcy, a buyout, or a debtor downgrade."[31] Most commonly, a credit event is a debtor default.[32] Since parties can customize what credit risk is involved in their agreement and what credit event would trigger payment, it has been difficult to regulate CDSs in the past because CDSs cannot be regulated with a one-size-fits-all standard.[33]

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18. *Id*.

19. Houman Shadab, *Credit Default Swaps and Regulatory Reform*, MERCATUS CTR. GEO. MASON U. 1, 1–2 (Aug. 2009), https://www.mercatus.org/publications/financial-markets/credit-default-swaps-and-regulatory-reform [https://perma.cc/NZ27-JJTQ].

20. DURBIN, *supra* note 1, at 2.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. Benjamin R. O'Connor, *Taming the Wild West of Wall Street: Regulating Credit Default Swaps After Dodd-Frank*, 48 J. MARSHALL L. REV. 565, 572 (2015).

26. *Id.*

27. *Id*. at 573.

28. *Id.*

29. *Id.*

30. The International Swaps and Derivatives Association (ISDA) definitions include six common credit events: bankruptcy, failure to meet payment obligation, obligation acceleration, obligation default, repudiation/moratorium, and restructuring. GEOFFREY P. MILLER & FABRIZIO CAFAGGI, THE GOVERNANCE AND REGULATION OF INTERNATIONAL FINANCE 39 (2013).

31. O'Connor, *supra* note 25, at 575.

32. *Id*. at 573.

33. *Id*. at 576.

CDSs can function like insurance.[34] The protection seller insures the protection buyer against the risk of loss if the credit event occurs, and the protection buyer pays a premium for this so-called insurance.[35] CDSs differ from insurance contracts in several ways. For example, the protection buyer does not own the underlier so "the purchaser of the CDS protection has no real 'insurable interest' to preserve."[36] Due to the lack of regulation of CDSs, the only place they could be bought and sold was in over-the-counter (OTC) markets.[37] Lack of regulation and the nature of the OTC market allowed investors the freedom to speculate with little oversight.[38] Investors were no longer looking for good investments in CDSs, and they were not trying to hedge risk.[39] Instead, they would speculate about how likely it was a credit event would occur. If a credit event did not occur, a protection seller could collect premium payments from protection buyers without ever paying the protection buyer.[40] This allowed protection sellers to agree to CDS contracts without the capital to back up any potential payout to the protection buyer on hand.[41] Protection buyers were also free to purchase bad debt and then use CDSs to protect against risk of loss.[42] If the credit event occurred, the protection seller would have to give the protection buyer money so the protection buyer did not face a loss.[43] Additionally, the number of protection buyers and protection sellers that can create a CDS on the same underlier is unlimited.[44] All of this together led to oversaturation in the CDS market, as well as rampant speculation.

"Derivatives and CDSs did play a part in the global financial crisis, but they did not cause it," Blyth Masters, Chief Financial Officer of JP Morgan—the same JP Morgan that invented the CDS—announced at a conference by the European Commission in 2009.[45] He was right. The influx of speculation in CDSs *contributed* to the cause of the Financial Crisis in 2008 but did not *cause* it. The cause is largely attributed to mortgage-backed securities being used as underlying assets for numerous kinds of transactions.[46] Credit rating agencies gave subprime mortgage-backed securities AAA ratings even though many of them should have received lower ratings or even junk status.[47] When the mortgage bubble burst, homeowners began defaulting on their mortgages in droves, causing the crisis.[48] CDSs had a role in this because financial institutions used CDSs to hedge risk and limit their credit exposure.[49] However, more often, CDSs were used to speculate.[50] CDSs

34. *Id.* at 577.
35. *Id.*
36. O'Connor, *supra* note 25, at 577.
37. *Id.* at 578.
38. *Id.*
39. *Id.*
40. *Id.* at 579.
41. O'Connor, *supra* note 25, at 579.
42. *Id.*
43. *Id.*
44. *Id.* at 580.
45. MILLER & CAFAGGI, *supra* note 30, at 49.
46. *Id.* at 50.
47. *Id.*
48. Kimberly Amadeo, *The Causes of the Subprime Mortgage Crisis*, BALANCE (Sept. 17, 2020), https://www.thebalance.com/what-caused-the-subprime-mortgage-crisis-3305696 [https://perma.cc/D6TE-ZMSX].
49. *Id.*
50. *Id.*

"provided a golden opportunity for bearish investors to bet against the housing boom."[51] When the housing bubble burst, protection sellers—who were in CDS contracts guaranteeing mortgage debts—suddenly had to come up with large amounts of capital to fund payouts to protection buyers.[52] Homeowners were defaulting on their mortgages at a much faster rate than protection sellers could come up with capital for payouts.[53] This led to more and more defaults in other sectors in addition to mortgages.[54] Many protection sellers were unable to come up with enough capital to cover payouts to protection buyers, so they too began to default on CDSs.[55] The whole system of CDSs began to unravel.

The actions of insurance company, American International Group (AIG) represent a prime example of how CDSs contributed to the financial crisis.[56] AIG—which was one of the world's largest insurance companies—was a protection seller engaging in CDS contracts.[57] AIG's potential pay-out in the event the credit events (in this case defaults) occurred in every one of their CDS contracts was more than $500 billion.[58] AIG grossly underestimated the risk behind its CDS contracts and did not provide enough collateral to ensure pay-outs.[59] AIG was not able to control the risk it aimed to hedge,[60] and the company suffered from too much exposure to risk and greatly lacked liquidity to cover its obligations.[61] Ultimately the government had to intervene and provide AIG with the needed liquidity to save it from defaulting on its pay-outs.[62] If AIG had defaulted, it would have created a grave domino effect, potentially collapsing the entire financial system.[63] This and other contributors to the financial crisis prompted large government bailouts, bankruptcy, and financial ruin.[64]

C. Increased Regulation of CDSs Through the Dodd-Frank Act

The government responded to the Financial Crisis by passing the Dodd-Frank Act in 2010, which is over 800 pages and attempts to regulate most areas of finance.[65] Title VII of the Dodd-Frank Act is the first time the federal government has attempted to regulate credit derivatives.[66] One important provision of the Dodd-Frank Act is the insurgence of power and authority it gives to the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) to regulate different types of swaps, including CDSs.[67] The Dodd-Frank Act also mandates that all parties to a CDS contract

51. MILLER & CAFAGGI, *supra* note 30, at 50.
52. O'Connor, *supra* note 25, at 581.
53. *Id.*
54. *Id.*
55. *Id.*
56. MILLER & CAFAGGI, *supra* note 30.
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. MILLER & CAFAGGI, *supra* note 30, at 50.
62. *Id.*
63. *Id.*
64. O'Connor, *supra* note 25, at 581.
65. *Id.* at 582–83.
66. *Id.* at 583.
67. *Id.*

register with the agency dealing with the kind of swap in the contract.[68] The Dodd-Frank Act also prohibits "the federal government from bailing out any so-called 'swap entity.'"[69]

One of the most significant provisions of the Dodd-Frank Act requires all CDSs clear through public clearinghouses, which are similar to exchanges, instead of free-for-all, over-the-counter transactions.[70] A clearinghouse "serves as a mediator between the parties to a transaction."[71] Transactions can form, trade, clear, and settle at clearinghouses.[72] Instead of two parties entering into a contract with each other, the clearinghouse will enter into two separate contracts with each of the two parties.[73] A clearinghouse can decrease risk in three ways.[74] First clearinghouses take on the administrative functions of the market,[75] so parties do not depend on each other to create strong and detailed contract terms, for example. Second, clearinghouses analyze their members' credit quality ahead of time and require members to disclose information about their credit quality regularly.[76] "Third, if a party becomes unable to satisfy its obligations under an agreement registered and processed through the clearinghouse, then the clearinghouse assumes those obligations."[77] This means if a protection seller is unable to fund a payout, then the clearinghouse will step in and pay the protection buyer to ensure the protection buyer does not have to assume the risk it is supposed to be protected against.[78] Clearinghouses obtain capital from their members, which is how they can provide payouts if a protection seller is unable to.[79] By collecting capital from members, clearinghouses essentially rely on members to check themselves to ensure they are not assuming too much risk.[80] In theory, members will do this self-check because other members' capital is at stake.[81] Clearinghouses must register with the SEC or the CFTC.[82] This makes clearinghouses trustworthy third parties that can be supervised by regulators.[83] However, clearinghouses are not perfect and do not provide the high level of oversight needed to mitigate speculation in CDSs.[84]

Despite the sweeping changes brought forth by the Dodd-Frank Act, there is more work to be done to regulate CDSs. Increased regulation of CDSs should not be made regarding the substance or terms of a CDS agreement because limiting the terms of CDSs would destroy the characteristic of customization that makes CDS agreements so desirable. Instead, further regulation should focus on the external aspects that affect CDSs, such as funding sources—loans, for example—for protection sellers, increased standardization of

68. *Id.*
69. O'Connor, *supra* note 25, at 583.
70. *Id.* at 584, 589.
71. *Id.* at 589.
72. MILLER & CAFAGGI, *supra* note 30, at 53 n.37.
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. MILLER & CAFAGGI, *supra* note 30, at 53–54 n.37.
78. O'Connor, *supra* note 25, at 589.
79. *Id.*
80. *Id.* at 591.
81. *Id.*
82. *Id.* at 596.
83. O'Connor, *supra* note 25, at 590.
84. *Id.* at 592.

clearinghouses, and the expansion of the authority that clearinghouses hold in order to deter overly speculative CDSs from saturating the market.

III. WHERE CURRENT REGULATION OF CDSS STANDS TODAY

A. The Dodd-Frank Act and Its Aftermath

The Dodd-Frank Act was passed in the aftermath of the Financial Crisis.[85] Congress' goal with the Dodd-Frank Act was to not only address the problems brought on by the Financial Crisis, but also to ensure that such a crisis could never happen again.[86] The Dodd-Frank Act made sweeping regulations across several areas of the financial sector,[87] affecting nearly every part of the financial services industry from mortgages and securities to banks and insurance companies.[88] The Act also authorized federal agencies and financial regulatory bodies to create many new regulations.[89]

As detailed as the Dodd-Frank Act is, however, it has several weaknesses. For example, the Dodd-Frank Act shares some blame in creating obstacles that caused banks to lend less, which harmed economic growth.[90] Similarly, regulations in Dodd-Frank originally aimed to address abuses by larger banks and financial firms are in turn resulting in compliance issues for small community banks, forcing them to sell off assets.[91] The Dodd-Frank Act introduced thousands of pages of new and complex regulations that are imposed on all banks, big and small alike.[92] However, small banks and community banks are unable to afford the increased cost of developing a compliance department or expanding their already existing compliance departments.[93] Ninety percent of banks have revealed that compliance costs have risen since the Dodd-Frank Act was passed.[94] Community banks have been forced to stop offering certain products and services to keep up with the

85. *Id.* at 582.

86. *Id.*

87. *More Than Just Financial Reform: Analysis and Observations on the Dodd-Frank Wall Street Reform and Consumer Protection Act*, JONES DAY 6 (Aug. 2010), https://www.jonesday.com/en/insights/2010/08/more-than-just-financial-reform-analysis-and-observations-on-the-dodd-frank-wall-street-reform-and-consumer-protection-act [https://perma.cc/JGP2-M7LU] ("The Act . . . address[es] public anger over the 'bailout' rather than to the actual causes of the financial crisis[;] [d]elegates most detail and authority to regulatory agencies[;] [g]oes well beyond traditional financial institutions by mandating changes to corporate governance provisions that negatively affect all public companies[;] [i]mposes a significantly increased compliance burden on banks and other financial institutions that is likely to further industry consolidation[;] [c]reates a public market for derivatives that increases the cost of doing business for most corporations[;] [i]s likely to continue to limit access to capital by causing banks and other financial institutions to lend less to comply with enhanced regulatory requirements.").

88. Eric Revell, *Obama Signed the Dodd-Frank Wall St. Reform & Consumer Protection Act on This Date*, CAUSES (July 21, 2019), https://www.causes.com/articles/31648-obama-signed-dodd-frank-wall-st-reform-consumer-protection-act-date [https://perma.cc/Y677-HELW].

89. *Id.*

90. *Id.*

91. *Id.*

92. Jonathan Sargent, *Community Banks Under Siege by Dodd-Frank*, AMS. FOR TAX REFORM (Oct. 14, 2016, 12:39 PM), https://www.atr.org/community-banks-under-siege-dodd-frank [https://perma.cc/8RWF-AQQ5].

93. *Id.*

94. Hester Peirce et al., *How are Small Banks Faring under Dodd-Frank?* 34 (Mercatus Ctr. Geo. Mason U., Working Paper No. 14-05, 2014), https://www.mercatus.org/system/files/Peirce_SmallBankSurvey_v1.pdf [https://perma.cc/PNJ7-AKU8].

increased cost of compliance.[95] Many smaller banks have been sold to larger banks.[96] Larger banks have the capacity to absorb the increased cost of compliance due to the Dodd-Frank Act;[97] thus, by subjecting banks of all sizes to nearly identical regulation, the Dodd-Frank Act has had a devastating effect on small banks and community banks.[98] However, critics on the other side of the spectrum wish the Dodd-Frank Act went further by breaking up large banking institutions and holding institutions that received large multi-billion-dollar bailouts, like Fannie Mae and Freddie Mac, more accountable.[99]

Title VII of the Dodd-Frank Act sets out regulations applying to swap markets.[100] However, these regulations do not apply to derivatives that are "not concluded by a counter-party that is the end user and it is hedging its own commercial risk with the swap."[101] In Title VII, the Dodd-Frank Act expands the regulatory functions of the Securities and Exchange Commission (SEC), in charge of regulating security-based swaps, and the Commodity Futures Trading Commission (CFTC), in charge of regulating non-security-based swaps.[102] For example, swap dealers and all other participants in the swap market must register with and be examined by the CFTC or the SEC depending on whether they deal with security-based swaps or other types of swaps, like swaps on commodities.[103] Before the Dodd-Frank Act, the SEC and CFTC were severely limited in how they could regulate OTC derivatives.[104] The Commodity Future Modernization Act (CFMA) was passed by Congress in 2000,[105] overriding the Commodities Exchange Act (CEA).[106] Under the CEA, derivative contracts, then codified as difference contracts, were not legally enforceable if they were too speculative.[107] Derivative contracts made for hedging purposes were the only ones that were legally enforceable.[108] Speculation was allowed, but if courts refused to enforce the derivative contract, parties were left on their own to figure out how to enforce their contracts.[109] According to the CFMA, the SEC and the CFTC were not allowed to regulate OTC swaps markets.[110] The only authority the SEC had over swaps markets was anti-fraud authority over security-based swap agreements.[111]

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95. Sargent, *supra* note 92.

96. *Id.*

97. *Id.*

98. *Id.*

99. Revell, *supra* note 88.

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

101. MILLER & CAFAGGI, *supra* note 30, at 54.

102. "Before commencing any rulemaking or issuing an order regarding swaps, swap dealers, major swap participants, swap data repositories, derivative clearing organizations with regard to swaps, persons associated with a swap dealer or major swap participant, eligible contract participants, or swap execution facilities pursuant to this subtitle, the Commodity Futures Trading Commission shall consult and coordinate to the extent possible." Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 8302(a)(1) (2010).

103. MILLER & CAFAGGI, *supra* note 30, at 54.

104. *Derivatives*, SEC (May 4, 2015), https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml [https://perma.cc/7GZY-8SDQ].

105. *Id.*

106. MILLER & CAFAGGI, *supra* note 30, at 45.

107. *Id.* at 47.

108. *Id.*

109. *Id.*

110. *Derivatives*, *supra* note 104.

111. *Id.*

Anti-fraud authority was broad but simultaneously restrictive.[112] The SEC was explicitly not allowed to impose reporting requirements, require recordkeeping, or mandate disclosure requirements, which severely limited the SEC's ability to make anti-fraud regulations.[113] Furthermore, in the same year, the State of New York Insurance Department decided that CDS agreements would not fall under their oversight despite having some attributes that function like insurance.[114] The State of New York Insurance Department determined pay-outs triggered by credit events do not depend on any sort of loss suffered by the buyer, and therefore, CDSs would not be regulated by the Department.[115] These two occurrences left CDSs highly unregulated and shifted derivatives from a small and regulated market to a largely unregulated OTC market.[116] A decade later, the Dodd-Frank Act completely overhauled the CFMA.

B. The International Swap Derivatives Association as Self-Regulators

Besides the Dodd-Frank Act, an additional body that attempts to regulate CDSs is the International Swap and Derivatives Association (ISDA). However, the ISDA has a different reason for targeting CDSs. The ISDA is one of the world's biggest financial trade associations and strives to reduce sources of risk in the private derivatives industry.[117] It was founded in 1985 by 18 swap dealers and now has over 820 members from 57 countries.[118] After the CFMA was passed, the ISDA stepped up as a "private industry self-regulator."[119] The ISDA created standard contract forms, published definitions, created supplemental documents, and more, publishing everything in several languages to facilitate use around the world.[120] One of the most significant documents created by the ISDA—in the aftermath of the deregulation of derivatives by the CFMA—was the ISDA Master Agreement, which was released in 2002.[121] The ISDA Master Agreement is typically signed by parties before they conduct a derivatives transaction.[122] The ISDA Master Agreement specifies "the obligations and representations of each party, and the relevant events of default and termination . . . [and] also define[s] the market conventions to be followed in derivatives transactions."[123] While the ISDA contributed to reforms at a time when regulations on derivatives were being eliminated and still continues to produce useful reforms and documents today, its reach is limited to its members and it has little enforcement power. It was not until the Dodd-Frank Act was passed that all derivatives were subjected to enforceable regulations once again.

C. Where the Dodd-Frank Act Went Wrong

By expanding the authority of the SEC and the CFTC, the Dodd-Frank Act limited its

112. *Id.*
113. *Id.*
114. MILLER & CAFAGGI, *supra* note 30, at 45.
115. *Id.*
116. *Id.* at 46.
117. *Id.* at 40.
118. *Id.*
119. MILLER & CAFAGGI, *supra* note 30, at 41.
120. *Id.* at 41–42.
121. *Id.* at 42.
122. *Id.*
123. *Id.*

authority as a statute and, in effect, deferred to these two agencies to do the heavy lifting when it came to regulating CDSs and other derivatives.[124] In a way, this makes sense. Agencies may be better informed and therefore more effective in rolling out regulations responding to changes in the finance world. But this can also work disadvantageously if the SEC and CFTC are unable to combat certain problems due to limitations in authority and enforcement capabilities. The SEC and CFTC may have more authority to regulate securities, but they do not have an unlimited amount of authority to address every suspicious type of swap. Furthermore, the Dodd-Frank Act uses fines as its main method of punishment,[125] essentially allowing the SEC to punish actors violating its regulations with fines.[126] This may not be effective, since the cost of being fined can be factored into financial transactions and the profit margin negotiated in financial transactions, minimizing the deterrent effect that fines are supposed to have.[127] The Dodd-Frank Act expands the authority of agencies like the SEC and the CFTC but does not give them enough power to use the authority as effectively as they need to.

Furthermore, the separation of the types of financial instruments regulated by the SEC and the types regulated by the CFTC can confuse swap market participants about which of the two agencies' regulations should be followed. For efficiency's sake, it is important to know which agency's regulations need to be followed when setting up a swap. The SEC and the CFTC have the discretion to tailor regulations to the types of swaps they regulate, so regulations can and do differ. Furthermore, swaps sometimes do not fit neatly within any of the definitions stated in the Dodd-Frank Act.[128] For instance, equity swaps and equity index swaps are swaps regulated by the CFTC.[129] However, if an equity swap or an equity index swap is security-based—for example, based on a single security or a narrow-based index—then those types of equity swaps and equity index swaps should technically be regulated by the SEC, not the CFTC.[130] This example shows how a swap can be set up in various ways, and how it can easily fall into the jurisdiction of the SEC when it would usually be regulated by the CFTC. Knowing which jurisdiction a swap falls under is important so a swap dealer will know which agency's regulations they must follow. This confusion is not addressed in Dodd-Frank and is even compounded by the Dodd-Frank Act through its separation of regulating duties between the SEC and CFTC depending on the type of swap.

There are other significant setbacks in the Dodd-Frank Act. Notably, the Dodd-Frank Act was passed as a response to past behavior by banks, financial institutions, and other financial actors.[131] The Dodd-Frank Act does not consider or focus on future innovations in the financial sector.[132] Financial markets are continuously changing and innovating. A decade ago, the credit default swap was an innovative financial instrument whose

124. Larissa Roxanna Smith & Victor M. Muniz-Fraticelli, *Strategic Shortcomings of the Dodd-Frank Act*, 58 ANTITRUST BULL. 617, 626 (2013).

125. *Id.*

126. *Id.*

127. *Id.* at 627.

128. JONES DAY, *supra* note 87, at 50.

129. *Id.*

130. *Id.*

131. Smith & Muniz-Fraticelli, *supra* note 124, at 624.

132. *Id.*

customizable nature made its use difficult to regulate.[133] Similarly, there are other innovations potentially entering the industry despite new, more strict regulations the Dodd-Frank Act implemented—for instance, narrowly tailored credit events, sometimes referred to as manufactured credit events. The ISDA characterizes narrowly tailored credit events as "arrangements with corporations that are narrowly tailored to trigger a credit event for CDS contracts while minimizing the impact on the corporation."[134] The ISDA amended its 2014 Credit Derivatives Definitions to incorporate this definition of narrowly tailored credit events.[135] Narrowly tailored credit events were created in 2013, after the Dodd-Frank Act was passed, but they did not garner much attention until 2017 when Hovnanian Enterprises used narrowly tailored credit events in its refinancing scheme and was sued by a CDS seller for market manipulation.[136] The ISDA released its 2019 Narrowly Tailored Credit Events Protocol, "NTCE Protocol," on July 15, 2019.[137] The cut-off date for adherence to the 2019 NTCE Protocol was moved from early October 2019 to Friday, November 8, 2019.[138] The ISDA 2019 NTCE Protocol was implemented on January 27, 2020.[139]

Narrowly tailored credit events trigger a credit event on credit default swap agreements referencing a company (referred to as a reference entity), but they are narrow so they will not impair the company's debt.[140] A reference entity and a protection buyer—that is the party paying premiums for protection—contract together and the protection buyer will offer financing to the reference entity with incredibly favorable terms.[141] The reference entity will then agree to default on debt payments, which will give the protection buyer the opportunity to profit on CDSs it bought from third parties.[142] Profiting from a CDS contract by using narrowly tailored credit events can saturate the market with CDS contracts created to make a profit.

Even though narrowly tailored credit events have been used since 2013, the SEC and the CFTC have been reluctant to begin regulating them. It has been nearly three years since Hovnanian Enterprises was sued for market manipulation because of the way it incorporated narrowly tailored credit events in its CDS contracts. However, little light has been shed concerning how narrowly tailored credit events should be regulated. During the summer of 2019, the chairman of the SEC, the chairman of the FCTC, and the chief director of the U.K. Financial Conduct Authority issued a Joint Statement on Opportunistic Strategies in the Credit Derivatives Market in an attempt to recognize the severity of manipulation possible by incorporating a narrowly tailored credit event:

> outline[s] mutual concerns about the pursuit of these [opportunistic] strategies

133. O'Connor, *supra* note 25, at 576.

134. *2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions*, INT'L SWAPS & DERIVATIVES ASS'N 3 (2019), https://www.isda.org/book/2019-narrowly-tailored-credit-event-supplement-to-the-2014-isda-credit-derivatives-definitions/ [https://perma.cc/P74R-KENC].

135. *Id.*

136. *Decision Time for the ISDA 2019 Narrowly Tailored Credit Events Protocol*, JONES DAY (Sept. 2019), https://www.jonesday.com/en/insights/2019/09/decision-time-for-the-isda [https://perma.cc/6C4A-DKH].

137. INT'L SWAPS & DERIVATIVES ASS'N, *supra* note 134.

138. *Id.*

139. *Id.*

140. JONES DAY, *supra* note 136.

141. *Id.*

142. *Id.*

> and the adverse impact they may have on the integrity, confidence and reputation of the credit derivatives market, as well as markets more generally. These opportunistic strategies include, but are not limited to, what have been referred to as 'manufactured credit events' or 'narrowly tailored credit events'.[143]

An updated version of the Joint Statement acknowledged the ISDA 2019 Narrowly Tailored Credit Events Protocols, even giving a nod of approval, saying "[w]e welcome these efforts."[144] However, in the Joint Statement, the SEC and CFTC were quick to say the ISDA Protocols were not comprehensive and did not address everything of concern.[145] The SEC and CFTC have yet to propose any regulations to address narrowly tailored credit events.[146] The lack of action by the SEC and the CFTC regarding the regulation of narrowly tailored credit events exemplifies the failure of the Dodd-Frank Act to account for future innovations in the financial sector.

By delegating most of its power to agencies, such as the SEC and the CFTC, the Dodd-Frank Act weakened its authority to regulate the derivatives market. It also introduced ambiguities in determining which agencies regulate certain types of financial instruments, such as swaps. One of the biggest setbacks of the Dodd-Frank Act is that it did not account for mechanisms used to regulate future innovations in the financial markets to promote fraud. Additions to the Dodd-Frank Act or even entirely new legislation is needed in order to more thoroughly regulate derivatives and other financial instruments.

IV. RECOMMENDATION

A. Limits on Funding Sources for Protection Sellers

One way CDSs can be regulated is to target their sources of funding. Restrictions on the number of loans a protection seller can take out to pay off a CDS contract in the event of a negative credit event may deter protection sellers from entering into overly speculative CDS contracts. If a negative credit event were to occur, then restrictions on loans could make it more difficult for a protection seller to raise the funds to cover the amount of the pay-out. As a result, only protection sellers with large amounts of cash on hand would be able to enter into a CDS contract involving a large pay-out. This would decrease the number of protection sellers in the market as well. Many protection sellers will be unable to enter into several CDS agreements if they are unable to easily secure funding.

Protection sellers also may be unwilling or unable to enter into CDS agreements dealing with large amounts of money if they are only able to rely on their own finances for funding. This could be positive or negative depending on the details of the agreement. Not being able to enter into CDS agreements involving large amounts of money has the potential to deter manipulation in the CDS market, since large payouts will not be possible.

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143. Jay Clayton et al., *Update to June 2019 Joint Statement on Opportunistic Strategies in the Credit Derivatives Market*, SEC (Sept. 19, 2019), https://www.sec.gov/news/public-statement/update-june-2019-joint-statement-opportunistic-strategies-credit-derivatives [https://perma.cc/56CM-AWE6].

144. *Id.*

145. "However, by itself, the proposed ISDA protocol will not address many of the concerns identified in the Joint Statement, such as opportunistic strategies that do not involve narrowly tailored credit events. We look forward to further industry efforts to improve the functioning of the credit derivative markets and welcome continuing engagement with market participants." *Id.*

146. *Id.*

On a negative note, it could potentially add an obstacle to protection buyers looking for protection sellers to enter into an agreement regarding a large transaction that would have a large payout (unless the protection seller has a large amount of cash on hand or the credit event does not occur and thus a pay-out is not triggered). However, such an obstacle can also deter risky borrowing or speculative investing through CDS agreements.

It may be difficult to track whether banks are giving loans for the purpose of a protection seller paying out a CDS contract, especially if the loans are taken out from one institution and the CDS contract is handled by another. One way to address this would be to extend authority to clearinghouses to investigate the funding sources for CDS pay-outs. For example, the extended authority of clearinghouses might allow them to require financial disclosures from protection sellers, who are required to pay out a certain number of days after the credit event occurred or require financial disclosures from all protection sellers (regardless of whether the credit event in their CDS agreements have occurred or not).

Limiting funding sources for protection sellers may saturate the market with protection sellers with deep pockets. This could lead to a positive or a negative outcome. Clearinghouses offset risk by requiring collateral from parties entering into a CDS agreement.[147] Clearinghouses also act as a stand-in to mitigate losses to the protection buyer in case a protection seller is unable to pay out the entire amount agreed to.[148] A restriction on sources of funding for protection sellers may put clearinghouses in the precarious position of stepping in if a protection seller cannot pay out the full amount more often than this occurs now. However, restricting sources of funding may prompt protection sellers to self-regulate and only enter into CDS agreements they can actually afford in the event of a pay-out being triggered. This would decrease the likelihood of a clearinghouse having to step in if a protection seller cannot afford the pay-out.

B. Increasing Regulation of Clearinghouses and Expansion of Authority

Another way that CDSs can be better regulated is through the increased regulation of clearinghouses. Since every CDS must be cleared through a clearinghouse,[149] clearinghouses are already in a position to help protect against increasingly speculative CDSs or manipulated credit events that are embedded in CDS contracts. By "requiring each [party] to post appropriate collateral, a well-capitalized clearinghouse prevents counterparty defaults from propagating into the financial system."[150] Requiring collateral is only a precaution, however, not a fool-proof method to ensure each pay-out is adequately financed and fulfilled. "Clearinghouses, however, are not panaceas. In the fight for market share, they may compete by lowering their operating standards, demanding less collateral from their customers, and requiring less capital from their members."[151] Clearinghouses need to be regulated and should have standardized requirements in terms of required collateral and membership capital. Clearinghouses should not be able to "compete" for

147. Squam Lake Working Grp. on Fin. Regul., *Credit Default Swaps, Clearinghouses, and Exchanges* 3–4 (Council on Foreign Rels., Working Paper 2009), https://www.cfr.org/report/credit-default-swaps-clearinghouses-and-exchanges [https://perma.cc/L6UB-UGDN].

148. *Id.*

149. O'Connor, *supra* note 25, at 583.

150. Squam Lake Working Grp. on Fin. Regul., *supra* note 147, at 3–4.

151. *Id.*

members or try to get "business." Clearinghouses have evolved as a new type of powerhouse and are emerging as "a new group of institutions that are too big to fail."[152] Clearinghouses are made up of members who provide capital. This capital, in turn, is used to fund defaulted payouts. The risk is essentially spread across all of the members, which means if one party defaults, its repercussions are felt by other members.[153] Furthermore, most clearinghouses are for-profit,[154] so an increased volume of transactions yields increased profits. Losses are spread among members.[155] The goal of increasing profits typically drives a decrease in standards,[156] such as a reduced amount of collateral or capital required from members. To control this business, clearinghouses are requiring standardized methods to determine how much capital to collect from members and a standardized formula to calculate the amount of collateral a party needs to put up. For example, this could be a percentage of the amount of the pay-out, while the capital requirement from members could be based on a percentage of the party's revenue.

Since clearinghouses are emerging as the next "too big to fail" entities, what precautions can be taken in the event clearinghouses do actually fail? If a clearinghouse fails, then numerous CDS agreements would be without protection or regulation.[157] Protection buyers will lose the guarantee of receiving their pay-outs via the clearinghouse if the protection seller is unable to pay. Members looking to enter into new CDS agreements will be without a clearing method and may have to scramble to become members of other clearinghouses. The worst-case scenario is CDS agreements becoming a free-for-all, returning to the essentially unregulated status they had before the Financial Crisis. Unfortunately, the Dodd-Frank Act only has precautions to help clearinghouses if they are failing and is silent on what steps to take if clearinghouses have already failed.[158] The Act gives regulators authority to categorize clearinghouses as "systematically important," which subjects clearinghouses to more oversight.[159] The Dodd-Frank Act also allows the Federal Reserve to give emergency funding to clearinghouses from the Federal Reserve's discount window.[160] The precautions in the Dodd-Frank Act regarding failing clearinghouses pretty much end there. As of now, if clearinghouses not designated as "systematically important" fail, they would be at the mercy of bankruptcy proceedings as the only method of recovery available after failure.[161]

Title II of the Dodd-Frank Act, the Orderly Liquidation Authority, authorizes regulators to take control of troubled financial institutions whose failure could have widespread ramifications potentially affecting the financial system.[162] However, it is unclear whether clearinghouses would qualify as such a financial institution, and clearinghouses are not specifically mentioned. To be covered under Title II, financial

152. *Flight to Safety: Have Regulators Created a New Type of Financial Monster?*, 431 ECONOMIST 63, 64 (2019).

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. David Skeel, *What if a Clearinghouse Fails?*, BROOKINGS (June 6, 2017), https://www.brookings.edu/research/what-if-a-clearinghouse-fails/ [https://perma.cc/Q4GP-QAEM].

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. Skeel, *supra* note 157.

institutions must be "predominantly engaged in activities that are financial in nature."[163] However, the Federal Deposit Insurance Corporation (FDIC) does not include clearing activities in any definition of "activities that are financial in nature."[164] Clearinghouses are clearly engaged in financial activities and their failure would have widespread consequences affecting several areas of the financial system, so it would make sense for them to be counted among the financial institutions covered under Title II. However, ambiguous definitions in the Dodd-Frank Act leave uncertain whether clearinghouses would be eligible to be taken over by regulators in case of failure. Amending Title II to explicitly include clearinghouses would fix this problem; however, Title II would still only apply to clearinghouses deemed systematically important. Title II also gives the FDIC the power to take control of these financial institutions at risk of failing.[165] The SEC and the CFTC would likely be better equipped to regulate clearinghouses,[166] rather than the FDIC, so this would also need to be amended in the Dodd-Frank Act. Clearinghouses are essential to the increased regulation of CDSs, so it is important to make sure they are well-regulated and that precautions are taken to make sure there are protocols in place in case clearinghouses fail.

To regulate CDSs, it is important to limit the regulation of the substance of a CDS agreement. Limiting the terms of a CDS agreement would defeat the benefit of a CDS: its ability to be customized. Instead, increased regulation of facets which can affect a CDS, like funding sources for protection sellers, can act as a deterrent against speculative CDSs. Furthermore, increased standardization of clearinghouses can mitigate the incentive of making large profits, leading to decreased requirements from members. Expanding the authority of clearinghouses—for example, allowing clearinghouses to require more financial disclosures from members and impose stricter collateral requirements—can also discourage members who are likely to default in their pay-out payments from entering into CDS agreements in the first place. This would save the clearinghouse from having to step in and fund the pay-out.

V. CONCLUSION: CDSS NEED MORE REGULATION BUT NOT AT THE COST OF CUSTOMIZATION

The Dodd-Frank Act left a lot to be desired in terms of regulating CDSs. While the Dodd-Frank Act did introduce sweeping regulations, it did not anticipate new developments related to CDSs, such as narrowly tailored credit events. Mandating the use of clearinghouses in CDS transactions was a major feat of the Dodd-Frank Act; however, clearinghouses must be more standardized to make them efficient in reducing risk and speculation. Today, clearinghouses are allowed discretion in determining requirements for membership and required disclosures in CDS agreements between members. This gives clearinghouses the power to, in effect, allow a potential "bad deal" to occur. A

163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*

clearinghouse does not mind doing this because the risk is spread to all of its members. Increased standardization in these practices will take away the power of discretion from clearinghouses. Furthermore, since clearinghouses play a large role in CDS transactions, they should be afforded more authority to work to protect against risky speculation. Increased standardization of clearinghouses will clear the path to giving them more authority without having to worry about consolidation of too much power.

Another way to regulate CDS agreements without sacrificing their customizability is to limit the amount of funding or loans that a protection seller can take out to use to fund a default payment in the event of a negative credit event. This will help ensure that protection sellers only take on CDS contracts that they can fund themselves, with their own financial resources, in the event of a payout. It is important to preserve the customizable nature of the Credit Default Swap because their ability to be customized is what makes them desirable. Implementing increased restrictions on funding sources and loans to supplement Dodd-Frank regulations will continue to preserve customizable Credit Default Swaps while providing prudent oversight to protect the industry from another collapse.