

The Role of Derivatives in the
Financial Crisis

Testimony
of
Michael Greenberger
Law School Professor
University of Maryland School of Law

Financial Crisis Inquiry Commission Hearing
Dirksen Senate Office Building, Room 538
Washington DC
Wednesday, June 30, 2010, 9am EDT

TABLE OF CONTENTS

	<u>Page</u>
Table of Contents	i
Introduction	1
The History of Derivatives and Derivatives Market Regulation	1
<i>The Early Derivatives Market</i>	1
<i>The Origins and Purposes of the Commodity Exchange Act</i>	1
<i>The Nature of Futures Contracts</i>	2
<i>The Contours of the Exchange Trading Requirement</i>	2
<i>The Development and Characteristics of Swaps</i>	3
<i>Swaps and the CEA's Exchange Trading Requirement</i>	4
<i>The Standardization of Swaps Through the ISDA Master Agreement</i>	5
<i>The CFTC's May 1998 Concept Release</i>	5
<i>Pre-1998 Swaps Market Dysfunctions</i>	6
<i>Opposition to the CFTC Concept Release</i>	7
<i>The LTCM Crisis</i>	7
<i>The President's Working Group's 1997 Report on LTCM</i>	8
<i>The Counterparty Risk Management Policy Group Report on the LTCM Crisis</i>	8
<i>The 1999 PWG Report Recommending Deregulation of Swaps</i>	9
<i>The Commodity Futures Modernization Act of 2000's Deregulation of Swaps</i>	9
<i>Conclusions About the Deregulatory Effect of the CFMA</i>	10
Credit Default Swaps and the Economic Meltdown in the Fall of 2008	11
<i>The Swaps Market in the Fall of 2008</i>	11
<i>Widespread Recognition That CDS Played Key Role in the Meltdown</i>	11
<i>The Pre-meltdown Actions on CDS of the NY Fed and the CRMPG</i>	13
<i>How CDS Were Used to Undermine the Subprime Market</i>	14
<i>How CDS Worked</i>	14
<i>The CFMA Eliminated All Fail Safes for CDS</i>	14
<i>The Motivations for Underwriting Subprime CDS</i>	15
<i>CDS Encourage Subprime Investments</i>	15

<i>Naked CDS Encourages Widespread Betting on the Subprime Market</i>	15
<i>The Taxpayer Is the Lender of Last Resort to the Bankrupt CDS Casino</i>	16
<i>Conclusions to Be Drawn about Subprime CDS</i>	17
Interconnectedness: The Systemic Risk Derived from All Types of Swaps	18
<i>Swaps Other Than CDS Have Caused Serious Financial Dislocations</i>	18
<i>Unregulated OTC Derivatives of All Kinds Cause “Too Big To Fail”</i>	18
<i>The Lehman Bankruptcy</i>	18
<i>Bear Stearns Interconnectedness</i>	19
<i>AIG Interconnectedness</i>	19
<i>The Interconnectedness Problems of Resolution Authority</i>	20
<i>All Swaps Are Masked By Opaque Accounting Principles</i>	21
Conclusion	21

Introduction

I have been asked by the Commission to address the following four questions in my testimony:

- The history of derivatives and derivatives market regulation;
- The structure of the derivatives market at the start of the financial crisis;
- How derivatives and derivatives markets functioned during the financial crisis;
- The role of over the counter (“OTC”) derivatives in the financial crisis, distinguishing, if appropriate, between the role of credit derivatives and other OTC derivatives, and the roles they may have played in amplifying and spreading the crises.

I deal with these questions immediately below.

The History of Derivatives and Derivatives Market Regulation

The Early Derivatives Market. Beginning in 1865, farmers and grain merchants coalesced in Chicago to hedge price risk in corn, wheat and other grains in what are thought to be the earliest sustained derivatives transactions in this country. These kinds of derivatives have been historically referred to as futures contracts.

Since their creation, these markets were recognized as being subject to price distortion (*i.e.*, rather than providing hedging, they can cause payments of unnecessary and unexpected higher or lower spot prices) through excessive speculation, fraud, or manipulation. As one disgruntled farmer told the House Agriculture Committee in 1892: “[T]he man who managed or sold or owned those immense wheat fields has not as much to say with the regard to the price of the wheat than some young fellow who stands howling around the Chicago wheat pit could actually sell in a day.”¹

The Origins and Purposes of the Commodity Exchange Act. Because low farm prices wrecked financial havoc on America’s agriculture sector during the Depression, President Roosevelt recommended to Congress, as one of his earliest market reform proposals, legislation that became the Commodity Exchange Act of 1936. When introducing this legislation in 1934, President Roosevelt said: “[I]t should be our national policy to restrict, as far as possible, the use of these [futures] exchanges for purely speculative operations.”² Accordingly, the 1935 Report of House Agriculture Committee stated: “The fundamental purpose of the measure [i.e., what was to become the Commodity Exchange Act of 1936 (“CEA”)] is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity

¹ Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States, 1875-1905*, AMERICAN HISTORICAL REVIEW 307 (2006)(quoting *Fictitious Dealings in Agricultural Products: House Comm. on Agric. Committee Hearing Reports* (1892)).

² President Franklin D. Roosevelt, Message to Congress, February 9, 1934.

which *too often demoralize the markets to the injury of producers and consumers and the exchanges themselves.*”³

Thus, the Commodity Exchange Act (“CEA”), as amended, required that all futures contracts be traded on a regulated exchange providing full transparency to trading behavior and the formation of futures prices.⁴ The exchange trading requirement of the CEA was so central to that statute’s policy that it is still a felony to knowingly violate it and substantial fines may be levied upon offending dealers and their employees.⁵

The Nature of Futures Contracts. “The traditional futures contract is an agreement between a seller and a buyer that the seller (called a short) will deliver to the buyer (called a long), at a price agreed to when the contract is first entered, and the buyer will accept and pay for, a specified quantity and grade of an identified commodity in the future.”⁶

While futures contracts were first developed for the agriculture sector, it expanded into metals and energy products. “[T]here has been a continual [further] expansion of the futures and derivatives market [to] [f]inancial futures – on government securities, private debt issues, foreign currencies and stock indexes – an increasingly important part of the commodities world.”⁷

“Standardization of terms is a key feature of publicly traded futures contracts. Under a futures contract, most customers do not expect to take delivery.... There is an opportunity to offset, and the customer has a right to liquidate rather than take [or make] delivery.”⁸ Only through the use of highly standardized products can the necessary liquidity be developed that allows traders the much needed ability to offset quickly delivery commitments in order to avoid unwanted delivery obligations.

One more recent accepted method of “avoiding delivery” is to “cash settle” the futures transaction based on the market price of the futures contract, a settlement process which has been deemed by the Commodity Futures Trading Commission (“CFTC”) to be wholly permissible under the CEA.⁹

The Contours of the Exchange Trading Requirement. As would be expected of a market regulation bill that followed in the wake of the Securities Acts of 1933 and 1934, the contours of futures exchange regulation closely mirrored the regulation of the equities markets, *i.e.*, futures contracts were required to be traded on publicly transparent and fully regulated exchanges supported by clearing mechanisms that ensure contractual commitments would be backed by adequate capital.¹⁰

³ Report No. 421, U.S. House of Representatives 74th Cong, Accompanying the Commodity Exchange Act, March 18, 1935 (emphasis added).

⁴ 7 U.S.C. § 6(a) (2009).

⁵ *Id.* § 13(b).

⁶ Phillip Mc Bride Johnson and Thomas Lee Hazen, DERIVATIVES REGULATION, §1.02[3] at 25 (Aspen, 2004) (hereinafter DERIVATIVES REGULATION).

⁷ *Id.* § 1.02 [1] at 11.

⁸ *Id.* at 24-25 n. 97.

⁹ *Id.* § 1.03[8] at 146-47.

¹⁰ *See id.*

Under the CEA specifically, regulated exchanges insured that futures contracts were subject to: (1) public and transparent pricing based on market demand; (2) disclosure of the real trading parties in interest to the federal government; (3) regulation of intermediaries; *i.e.*, brokers and their employers; (4) stringent rules for customer protection; (5) self regulation by exchanges directly supervised by a federal regulator to detect unlawful trading activity; (6) prohibitions against fraud, market manipulation and excessive speculation; and (7) enforcement of all these requirements by the federal regulator, private individuals and the states through private rights of action and state *parens patriae* suits, respectively.

As an integral part of this regulatory format, futures contracts also had to be cleared, *i.e.*, a well capitalized and regulated intermediary institution was required to stand between the counterparties of a futures contract to ensure that commitments undertaken pursuant to those contracts were adequately capitalized through the collection of margin.¹¹ Any contractual failure was guaranteed by the clearing facility, a financial commitment that served to insure that the clearing facility had a great incentive to strictly enforce the capital adequacy of traders through highly disciplined assessment of the market price of the futures position and immediate collection of initial margin upon executing the futures trade and of variation margin as the contract price moves against a counterparty to the trade.¹²

The Development and Characteristics of Swaps. By the 1980's, a variant of futures contracts was developed, commonly referred to as "swaps".¹³ When first addressing "swaps" contracts, the CFTC defined them as "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchanges rates, or prices with payment calculated by reference to a principal base (notional amount)."¹⁴ Similarly, the International Swaps Derivatives Association ("ISDA") defines a "swap" as "[a] derivative where two counterparties exchange streams of cash flows with each other. These streams are known as the "legs" of the swap and are calculated by reference to a notional amount."¹⁵

A classic example of an interest rate swap transaction is where one party to the agreement exchanges a floating interest rate obligation on an existing loan for a fixed rate obligation to be paid by a swaps dealer or by another counterparty to which the swap has been assigned by the swaps dealer. Usually, the person swapping the floating rate for a fixed rate is expecting (or hedging against the fact) that the fixed rate will be lower than the floating rate.

In other words, the loan is usually neither negotiated nor renegotiated under the swap. It is an assumed amount written into the swap, most often reflecting an actual outstanding loan of one of the swaps customers from a creditor or lender upon which a floating rate is being paid to the lender. The fixed interest rate payments paid by the swaps dealer to the borrower would also be specified in the transaction, as would the manner in which the floating rate would be calculated. Thus, rather than buying/selling a *single* future rate or price (as would be true in a traditional futures contract), there is a "swapping" of commitments with one party buying the

¹¹ *See id.* § 1.18.

¹² *See id.* § 1.18.

¹³ *See* DERIVATIVES REGULATION § 102[12A] at 29-30 (Supp. 2010).

¹⁴ 54 Fed. Reg. 30694 (July 21, 1989).

¹⁵ DCG Glossary, International Swaps and Derivatives Association, Inc. website, *available at* http://www.isda.org/c_and_a/oper_commit-dcg-glossary.html (last visited June 27, 2010).

fixed rate and selling the floating rate while the other party is buying the floating rate and selling the fixed rate.

Swaps and the CEA's Exchange Trading Requirement. After “swaps” contracts had been developed by the banks/dealers in the 1980s, with a simultaneous recognition that “swaps” contained all the features of a futures contract, the question arose whether swaps would be subject to the mandatory exchange trading requirement of the CEA. In a 1989 Policy Statement, the CFTC set forth the criteria for the kind of swaps for “which regulation under the CEA and Commission regulations [of swaps would be] unnecessary.”¹⁶ The CFTC recognized that swaps at that time required:

“[t]ailoring . . . through *private* negotiations between the parties and may involve not only financial terms but issues such as representations, covenants, events of default, term to maturity and any requirement for the posting of collateral or other credit enhancement. Such *tailoring* and counterparty credit assessment distinguish swap transactions from exchange transactions, where the contract terms are standardized and the counterparty is unknown.”¹⁷

Accordingly, the CFTC exempted swaps from the CEA exchange trading requirement by stating that “swaps must be negotiated by the parties as to their material terms, based upon individualized credit determinations, and documented by the parties in an agreement or series of agreements that is not fully standardized.”¹⁸ Another condition of the exchange trading exemption is that “[t]he swap must not be marketed to the public.”¹⁹

Because the CEA provided no explicit provision authorizing the CFTC to grant an exemption from the CEA’s exchange trading requirement such as that found in the CFTC’s 1989 Policy Statement, swaps dealers/banks contended that there was “uncertainty” as to the legal effect of that policy statement. Thus, Congress in 1992 passed the Futures Trading Practices Act (“FTPA”), adding a new § 4(c)(5)(b) to the CEA which authorized the precise criteria for the CFTC to create exemptions from the CEA’s mandatory exchange trading requirement for, *inter alia*, “swaps agreements,” which “are not part of a fungible class of agreements that are standardized as to their material economic terms . . .”²⁰

The Commission later explained this statutory bar to standardization of swaps transactions as follows: “This condition [that swaps be individually negotiated] is designed to assure that the exemption does not encompass . . . swap agreements, *the terms of which are fixed and are not subject to negotiation*, that functions essentially in the same manner as an exchange but for the bilateral execution of transactions.”²¹

Pursuant to the CFTC’s ability to grant exceptions to the CEA’s exchange trading requirement authorized by the 1992 FTPA, the CFTC by rule in 1993 provided an exception

¹⁶ 54 Fed. Reg. 30694 (July 21, 1989).

¹⁷ *Id.* (emphasis added).

¹⁸ *Id.*

¹⁹ DERIVATIVES REGULATION § 1.02[5] at 43.

²⁰ Pub. L. No. 102-546.

²¹ 58 Fed. Reg. 5587 (Jan. 22, 1993) (emphasis added).

from the CEA's exchange trading requirement for those swaps that were, *inter alia*, "not part of a fungible class of agreements that are standardized as to their material economic terms[.]"²² Moreover, exempt swaps agreements were not to be "traded on or through a multilateral transaction execution facility."²³ In laymen's terms, "a multilateral transaction execution facility" consists of one party offering electronically a swaps agreement to many different other parties, rather than merely offering agreements on a bilateral or one-on-one basis.

The Standardization of Swaps Through the ISDA Master Agreement. However, even before the 1993 CFTC rule calling for negotiation of each of the material economic terms of swap was promulgated, the International Swaps and Derivatives Association (known then as the International Swaps Dealers Association) in 1992 created a standardized and copyrighted Master Agreement and related schedule to govern the execution of a swap. ISDA "was chartered in 1985 and today has over 825 member institutions."²⁴

The ISDA Master Agreement is 18 pages long with standardized, boilerplate clauses, and each page carries with it a copyright in ISDA's name. It includes the fundamental provisions without which the swaps transaction could not be understood. Included among the many contractual points resolved by the ISDA Master Agreement are "interpretation" principles (§ 1); "obligations", including "liability" (§2); "representations" (§3); "agreements" (§4); "events of default and termination events" (§5); "early termination" (§6); "transfer" (§7); "contractual currency" (§8); "remedies" (§9); "expenses" (§11); "notice" (§12); "governing law and jurisdiction" (§13); and forty three "definitions" governing the swaps transactions (§14).

Accompanying the ISDA Master Agreement is a "Schedule," which is thirteen pages long, derived directly from a standardized ISDA template for that "Schedule," which, in turn, provides a standardized menu of limited choices to further define terms of the ISDA Master Agreement. The ISDA template for the Schedule is itself copyrighted on every page in ISDA's name. The ISDA standardized template for the Schedule is dependent upon, and references only, the ISDA Master Agreement.

Accompanying the ISDA Schedule is a standardized ISDA Credit Support Annex, which is sixteen pages long and also includes copyrights in ISDA's name on every page except those relating to the last of thirteen paragraphs. The first twelve paragraphs within the ISDA Credit Annex are standardized boilerplate written by ISDA. Every page is once again copyrighted in ISDA's name. Only the last paragraph concerning "elections and variables" is not standardized.

The CFTC's May 1998 Concept Release. By 1998, the over-the-counter (OTC) derivatives market was growing at a rapid pace. As the CFTC noted:

"Use of OTC derivatives has grown at very substantial rates over the past few years. According to the most recent market survey by [ISDA], the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-

²² 17 C.F.R. § 35.2(b) (2009).

²³ *Id.* at § 35.2(d).

²⁴ Eraj Shirvani New Chairman of ISDA, News Release, April 16, 2008, *available at* <http://www.isda.org/>.

month period. The notional value of outstanding contracts in these instruments was \$28.733 trillion, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994. ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of year-end 1996, up 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994. . . .”²⁵

Also, these OTC derivatives were now, because of the ISDA Master Agreement, so standardized that they could be traded electronically on a multilateral basis, thereby exhibiting all of the trading characteristics of traditional exchange traded standardized futures contracts.²⁶ Because swaps were increasingly standardized and traded multilaterally, however, the market was not within the “safe harbors” exemption from the CEA regulatory requirements and protections of the CEA provided by the 1989 Swaps Policy Statement or the 1993 Swaps exemption.

On May 7, 1998, the CFTC promulgated a “concept release” on “OTC Derivatives,” finding that these standardized products were almost certainly subject to the mandatory exchange trading requirement (and therefore were trading in violation of law) and calling for public comment on the development of various alternative regulatory features that would create an § 4 (c) exemption from the CEA’s mandatory exchange trading.²⁷

Any new regulatory system would be applied “prospectively,” with the existing market retroactively sanctioned under the CEA.²⁸ The public was asked to answer a series of questions pertaining to what, *if any*, of the features of a fully regulated exchange trading requirement should be applied to the swaps market, *e.g.*, reporting and disclosure, capital adequacy, clearing, exchange trading, regulation of intermediaries, self regulation or application of anti-fraud and anti-manipulation principles. The CFTC expressly stated that it had no preconceived notion of the answer to these questions.

Pre-1998 Swaps Market Dysfunctions. The motivation for this May 1998 CFTC inquiry was the fact that unregulated swaps had caused so many financial calamities. The CFTC noted:

“A number of large, well publicized, financial losses over the last few years have focused the attention of the financial services industry, its regulators, derivatives end-users, and the general public on potential problems and abuses in the OTC derivatives market. Many of these losses have come to light since the last major regulatory actions by the CFTC involving OTC derivatives, the swaps and hybrid instruments exemptions issued in January 1993.”²⁹

In footnote 6 of the concept release, the CFTC cited “Jerry A. Markham, *Commodities Regulation: Fraud, Manipulation & Other Claims*, Section 27.05 nn. 2-22.1 (1997) (listing 22

²⁵ 63 Fed. Reg. 26114, 26115 (May 12, 1998) available at http://www.cftc.gov/opa/press98/opamntn.htm#p60_8020.

²⁶ See 63 Fed. Reg. 26114 (May 12, 1998).

²⁷ *Id.*

²⁸ *Id.* at 26114.

²⁹ *Id.* at 26114, 26115.

examples of significant losses in financial derivatives transactions) [and] a 1997 GAO Report 4 (stating that the GAO identified 360 substantial end-user losses).”

The most prominent scandals deriving from swaps by May 1998 included the 1994 bankruptcy of Orange County, the largest municipal default in the Nation’s history. Orange County was one of the country’s wealthiest and fifth most populous. Having executed many poorly understood interest rate swaps, the county suddenly found itself facing massive debt as interest rates quickly rose. It lost approximately \$1.6 billion.³⁰ Merrill Lynch agreed to pay \$400 million to Orange County to settle claims involving the derivatives that caused Orange County’s bankruptcy.

Also beginning in 1994, two large corporate clients of Bankers Trust, Gibson Greetings and Procter & Gamble, successfully sued it for defrauding them in the sale of complicated unregulated derivatives, thereby causing large customer losses. Central to that litigation success were over 6500 tape recordings of Bankers Trust employees acknowledging to each other that the bank’s clients did not understand the adverse impact the derivatives transactions would have on them.

The SEC and CFTC took cooperative enforcement against Bankers Trust for violating the antifraud provisions of the federal securities and commodities laws in connection with OTC derivatives it marketed.³¹ The SEC found that Bankers Trust violated various sections of the securities laws, including making false statements or omissions in the sale of securities, supplying materially inaccurate valuations of derivatives transactions, and failing to supervise marketing personnel.³² The CFTC asserted that Bankers Trust, by its conduct, had assumed the role of a commodity trading advisor and had violated the antifraud provisions of the CEA governing such parties’ activities.³³

Opposition to the CFTC Concept Release. The CFTC’s sister agencies (the Treasury, the Fed, and the SEC) within the President’s Working Group were strongly opposed to the CFTC’s concept release inquiry.³⁴ In response to a request from the remaining members of the President’s Working Group on Financial Markets issued on the very day the concept release was published, Congress eventually enacted a six month statutory moratorium to the CFTC concept release.³⁵

The LTCM Crisis. However, in September 1998, Long-Term Capital Management (“LTCM”), which was up until that time the country’s largest and most successful hedge fund, nearly collapsed from the loss over a period of weeks \$4.6 billion (or about 90% of its capital) on losses from, *inter alia*, OTC derivatives positions. It was feared that LTCM’s failure would have

³⁰ Mark Baldassare, *WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 2-3* (1998).

³¹ U.S. Gov’t Accountability Office, *OTC Derivatives: Additional Oversight Could Reduce Costly Sales Practice Disputes* 8 (1997).

³² *Id.* at 44.

³³ *Id.* at 45-46.

³⁴ *Frontline: The Warning* (PBS television broadcast Oct. 20, 2009) (transcript available at <http://www.pbs.org/wgbh/pages/frontline/warning/etc/script.html>).

³⁵ See President’s Working Group on Financial Markets, *Over-the-Counter Market and the Commodities Exchange Act* (1999) at 13 (hereinafter “*PWG 1999 OTC Report*”).

created failure of many of its counterparties which were the hedge fund's OTC derivative counterparties and creditors, including some of the world's largest financial institutions. So concerned were those financial institutions about the systemic effect of LTCM's failure that, under the auspices of the New York Federal Reserve, on September 23, 1998 (with just about 48 hours of notice about LTCM's potential collapse) fourteen of those institutions contributed a total of \$3.6 billion to buy out the fund to keep it from failing.³⁶

The President's Working Group's 1997 Report on LTCM. After a full day of hearings before the House Financial Services Committee on October 1, 1998 on the LTCM crisis, the President's Working Group was asked to prepare a report on the LTCM failure and actions that might be recommended to prevent such a potentially systemic failure in the future. In April 1997, the PWG issued that report. It noted that: "The near collapse of [LTCM] highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system."³⁷

One of the major recommendations of the April 1997 PWG report was that the SEC, the CFTC and the Treasury receive expanded authority to require OTC derivative counterparties to provide credit risk information, recordkeeping and reporting and data on concentrations, trading strategies and risk models, as well as the ability to inspect risk management models.³⁸ Fed Chairman Greenspan declined to endorse this set of recommendations, but deferred to those regulators with supervisory authority.³⁹

The Counterparty Risk Management Policy Group Report on the LTCM Crisis. Shortly after the LTCM episode, twelve of the world's largest banks formed the Counterparty Risk Management Policy Group ("CRMPG") to conduct a self study of practices that led to the LTCM crisis and to recommend self regulatory practices that would prevent such an episode from reoccurring. In June 1999, CRMPG issued a detailed 57 page report, which acknowledged faulty supervision of OTC swaps' desks within their institutions and promised a broad array of management practices, including improved supervision and reporting and market practices pertaining to OTC derivatives. Included within CRMPG's recommendations was a commitment to meet informally and periodically with their primary regulator to discuss OTC "market trends and conditions," including providing reports "detailing certain large exposure information on a consolidated basis group."⁴⁰

Illustrative of a problem that would reoccur in these markets is an observation about the lack of proper documentation of OTC derivatives transactions. CRMPG states: "The global financial markets operate through an interconnected series of contracts among market participants. . . . Although written documents may not be, per se, necessary to establish a contract, *they are the best evidence of the terms of a contract and the best way to ensure that parties agree*

³⁶ Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Report of the President's Working Group on Financial Markets (April 1997) 10 -17.

³⁷ *Id.* viii.

³⁸ *Id.* 39-40.

³⁹ *Id.* 39, note 23.

⁴⁰ "Improving Counterparty Risk Management Practices," Counterparty Risk Management Policy Group, June 1999 10-11 available at <http://www.isda.org/educat/pdf/CRMPG-Report6-99.pdf>.

on the specific terms of a transaction. Failure to document a transaction appropriately or expeditiously, therefore, creates risk. . . .⁴¹

The 1999 PWG Report Recommending Deregulation of Swaps. The major thrust of the CRMPG report was to oppose “new regulation . . . It would be a mistake to attempt to codify risk management practices in that fashion.”⁴² Not only were no new regulations promulgated (nor were the informal meetings with regulators initiated proposed by CRMPG ever initiated), by November 1999, the PWG (in a seeming reversal from its April 1999 Report) was recommending to Congress that financial OTC derivatives totally be deregulated. In a cover letter for that report, then Secretary of the Treasury Lawrence Summers explained:

“Over-the-counter derivatives have transformed the world of finance, increasing the range of financial products available to corporations and investors and fostering more precise ways of understanding, quantifying, and managing risk. These important markets are large and growing rapidly. At the end of 1998, the estimated notional value of OTC derivative contracts was \$80 trillion, according to the Bank for International Settlements. In addition, these global markets have been marked by innovation in products and trading and settlement mechanisms.

A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore. . . .”

The central and key recommendation within the PWG 1999 Report with respect to “OTC derivatives” was that Congress provide “[a]n exclusion from the CEA [“s regulatory requirements] for bilateral transactions between sophisticated counterparties (other than transactions that involve non-financial commodities with finite supplies) . . .”⁴³

The Commodity Futures Modernization Act of 2000’s Deregulation of Swaps. Accordingly, on December 15, 2000, Congress passed and on December 21, 2000, President Clinton signed into law the Commodity Futures Modernization Act of 2000 (“CFMA”).⁴⁴ The CFMA removed OTC derivatives transactions, including energy futures transactions, from all requirements of exchange trading and clearing under the CEA so long as the counterparties to the swap were “eligible contract participants”. Generally speaking, a counterparty to be an “eligible contract participant” had to have in excess of \$10 million in total assets with some limited exceptions allowing lesser amounts in the case of an individual using the swap for risk management purposes.⁴⁵

Thus, the OTC derivatives market (at that time according to Secretary Summers amounting to \$80 trillion notional value) was exempt from the CEA’s capital adequacy

⁴¹ *Id.* 37 (emphasis added).

⁴² *Id.* 2

⁴³ *PWG OTC Report 1999 Report* at 2.

⁴⁴ Public Law 106-554, 114 Stat. 2763.

⁴⁵ DERIVATIVES REGULATION, § 1.18[5] at 328-29 (2004 ed.)

requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation⁴⁶ and excessive speculation; and requirements for clearing.

The SEC was similarly barred from OTC derivatives oversight except for the limited fraud jurisdiction it maintained over securities-based swaps. During the TARP hearings in September 2008, then-SEC Chairman Christopher Cox warned Congress about the need for “immediate legislative action,” because he viewed OTC credit derivatives market as a “regulatory blackhole.”⁴⁷

Recognizing that the deregulation of swaps would remove the Act’s bar against excessive speculation in regulated exchange traded futures, the CFMA also expressly preempted state gaming and anti-bucket shop laws,⁴⁸ which would have barred the otherwise unregulated speculative activity authorized by the CFMA.

Finally, to ensure that not even the CFMA itself could be used as a basis to challenge the legality of a swap, the Act provides that “[n]o agreement, contract, or transaction between eligible contract participants . . . shall be void, voidable, or unenforceable . . . based *solely on the failure . . . to comply with . . . this Act . . .*”⁴⁹

Conclusions about the Deregulatory Effect of the CFMA. In sum, what was then estimated to be this multi-trillion dollar OTC derivatives market was removed from almost all pertinent federal and state enforcement to which trading markets had been subject since the New Deal, as well as a central premise of the common law of contracts, *i.e.*, that illegal contracts are subject to a declaration of unenforceability. In effect, almost no law applied to this market.

⁴⁶ Unlike financial swaps, which were “*excluded*” from the exchange trading requirement, including fraud and manipulation prohibitions, energy and metals swaps, while relieved of the exchange trading, continued to be subject to fraud and manipulation prohibitions; they were therefore labeled by the CFMA as “*exempt*” transactions. Compare § 2(g) (relating to financial swaps) with § 2 (h) relating to energy and metals swaps. See also Charles W. Edwards, James Hamilton and Heather Montgomery, *Commodity Futures Modernization Act of 2000: Law and Explanation* at 28 (CCH, 2001) (hereinafter “*CFMA Law and Explanation*”) (quoting remarks of Sen. Tom Harkin, 146 Cong. Rec. S11896, December 15, 2000, “The Act continues the CFTC’s antifraud and anti-manipulation authority with regard to exempt transaction in energy and metals derivative markets.”). By exempting metals and energy swaps from exchange trading, Congress disagreed with the unanimous recommendation of the PWG that swaps concerning “finite” supplies not be removed from the exchange trading mandate of the CEA.

⁴⁷ Robert O’Harrow, Jr. and Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1 (stating “‘The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting on the current credit crisis,’ Cox said, ‘it requires immediate legislative action.’”).

⁴⁸ DERIVATIVES REGULATION § 4.04[11] at 975 (referencing 7 U.S.C. § 16(e)(2)).

⁴⁹ 7 U.S.C. § 25 (a) (4) (emphasis added).

Credit Default Swaps and the Economic Meltdown in the Fall of 2008

The Swaps Market in the Fall of 2008. In October 2008, the notional value of the unregulated OTC market was estimated to be in excess of \$ 600 trillion.⁵⁰ Included within that amount was estimated to somewhere between \$35-65 trillion in credit default swaps (“CDSs”).⁵¹

While the Federal Reserve has estimated generally that 3% of the notional amount of a swap is the amount at risk in swaps transactions, a credit default swaps’ insurance like aspects mean that if a default is triggered, the entire amount of the sum guaranteed is at risk. While the Federal Reserve’s 3% figure establishing amount at risk has been deemed by many (including me) to be far too low, combining even the *lower* figure for the value of outstanding CDS (\$35 trillion) in September 2008 with Fed’s 3% of the remaining notional value (\$565 trillion), the resulting amount at risk at the time of the meltdown (about \$52 trillion) almost equaled the world’s GDP. Even using the most conservative figures for the sake of argument, \$52 trillion is a very large figure.

Widespread Recognition That CDS Played Key Role in the Meltdown. It is now almost universally accepted that the unregulated multi-trillion dollar OTC CDS market helped foment a mortgage crisis, then a credit crisis, and finally a “once-in-a-century” systemic financial crisis that, but for huge U.S. taxpayer interventions, would have in the fall of 2008 led the world economy into a devastating Depression. Before explaining below the manner in which credit default swaps fomented this crisis, it worth citing in the margin those many economists,⁵²

⁵⁰ See Barrett Sheridan, *600,000,000,000,000? It's a number no one questions, but the size of the derivatives market is not as shocking as it looks*, NEWSWEEK, Oct. 18, 2008, available at <http://www.newsweek.com/2008/10/17/600-000-000-000-000.html>.

⁵¹ See Bank for International Settlements, *BIS Quarterly Review* (September, 2008), available at http://www.bis.org/publ/qtrpdf/r_qa0809.pdf#page=108.

⁵² See Ben Moshinsky, [Joe] Stiglitz says Banks Should Be Banned From CDS Trading, BLOOMBERG.COM, Oct. 12, 2009, <http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=a65VXsI.90hs> (last visited on June 25, 2010); Paul Krugman, Op-Ed., *Looters in Loafers*, N.Y. TIMES, April 18, 2010, available at <http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk> (last visited on June 27, 2010); Alan S. Blinder, *The Two Issues to Watch on Financial Reform - We need an independent consumer watchdog and strong derivatives regulation. Industry lobbyists are trying to water them down*, WALL ST. J., April 22, 2010, available at <http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html> (last visited on June 27, 2010); Written Statement of James K. Galbraith, *Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing Before the Subcommittee on Crime and Drugs, S. Judiciary Comm.*, May 4, 2010, available at <http://utip.gov.utexas.edu/Flyers/GalbraithMay4SubCommCrimeRV.pdf> (last visited on June 26, 2010); Henry T. C. Hu, *'Empty Creditors' and the Crisis*, WALL ST. J., April 10, 2009, at A13.

regulators,⁵³ market observers,⁵⁴ and financial columnists⁵⁵ who have described the central role unregulated CDS played in the crisis.

Even those once skeptical of arguments about the dangers of OTC derivatives have joined this chorus. In warning Congress about badly-needed financial regulatory reform efforts when it considered the TARP legislation in Senate hearings before the Senate Banking Committee in September, 2008, then-SEC Chairman Christopher Cox called the CDS market a “regulatory blackhole” in need of “immediate legislative action.”⁵⁶ Former SEC Chairman Arthur Levitt and even former Fed Chair Alan Greenspan—both of whom supported the CFMA

⁵³ See Remarks of Chairman Gary Gensler, OTC Derivatives Reform, Chatham House, London (March 18, 2010) (“OTC derivatives were at the center of the 2008 financial crisis. . . . Capital requirements should take into account the unique risks that credit default swaps (CDS) pose.”); Testimony of Alan Greenspan, Committee of Government Oversight and Reform (Oct. 23, 2008); Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 23, 2008, available at <http://www.nytimes.com/2008/10/24/business/economy/24panel.html> (last visited on June 22, 2010); Peter S. Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?pagewanted=all> (last visited on June 26, 2010); Anthony Faiola, *Ellen Nakashima and Jill Drew, The Crash Risk and Regulation: What Went Wrong*, WASH. POST, Oct. 15, 2008, available at http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343_pf.html (last visited on June 22, 2010); Greg Robb, *Roots of credit crisis laid at Fed's door*, MARKETWATCH, Oct. 24, 2007, <http://www.marketwatch.com/story/roots-of-credit-crisis-found-at-the-feds-door-says-expert> (last visited on June 26, 2010); Written Testimony of New York Insurance Superintendent Eric Dinallo, *Review of the Role of Credit Derivatives in the U.S. Economy: Before the H. Comm. on Agriculture*, Nov. 20, 2008, available at <http://www.ins.state.ny.us/speeches/pdf/sp0811201.pdf> (last visited on June 27, 2008).

⁵⁴ See Jonathan Berr, *George Soros wants to outlaw credit default swaps*, DAILYFINANCE, June 12, 2009, <http://www.dailyfinance.com/story/george-soros-wants-to-outlaw-credit-default-swaps/19065423/#> (last visited on June 26, 2010); Henny Sender, *Greenlight Capital founder [David Einhorn] calls for CDS ban*, FINANCIAL TIMES, Nov. 6, 2009, available at <http://www.ft.com/cms/s/0/6b1945e6-caf9-11de-97e0-00144feabdc0.html> (last visited on June 25, 2010); INVESTOR'S WORKING GROUP, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS' PERSPECTIVE (July 2009), available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf) (last visited on June 27, 2010); Janet Tavakoli, *Washington Must Ban U.S. Credit Derivatives as Traders Demand Gold (Part One)*, HUFFINGTON POST, March 8, 2010, available at http://www.huffingtonpost.com/janet-tavakoli/washington-must-ban-us-cr_b_489778.html (last visited on June 27, 2010).

⁵⁵ See Gretchen Morgenson, *Credit default swap market under scrutiny*, N.Y. TIMES, Aug. 10, 2008, available at http://www.nytimes.com/2008/08/10/business/worldbusiness/10iht-morgen11.1.15138610.html?_r=2&pagewanted=all (last visited on June 27, 2010); Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 4, 2008, available at <http://www.nytimes.com/2008/11/05/business/05swap.html> (last visited on June 27, 2010); Jon Hilsenrath, *Worst Crisis Since '30s, With No End In Sight*, WALL ST. J., Sept. 18, 2008; Jeff Madrick, *At the Heart of the Crash*, NY REVIEW OF BOOKS (May 11, 2010) (reviewing MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE*), available at <http://www.nybooks.com/articles/archives/2010/jun/10/heart-crash/?pagination=false> (last visited on June 27, 2010); LAWRENCE G. McDONALD & PATRICK ROBINSON, *A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS* (2009); Robert Johnson, *Credible Resolution – What It Takes to End Too Big to Fail*, in ROOSEVELT INSTITUTE, *MAKE MARKETS BE MARKETS* 117-133 (2009).

⁵⁶ “The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting on the current credit crisis,” Cox said, “it requires immediate legislative action.”). Robert O'Harrow Jr. and Brady Dennis, *Downgrades and Downfall*, WASHINGTON POST, Dec. 31, 2008, at A1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/30/AR2008123003431.html>.

in 2000—have acknowledged that the deregulation of the CDS market contributed to the fall 2008 economic downfall.⁵⁷

The Pre-meltdown Actions on CDS of the NY Fed and the Counterparty Risk Management Policy Group. Moreover, important actions taken by regulators and market participants in the prior years running up to the meltdown further indicate the central role that credit derivatives were to play in causing the meltdown. For example, in September 2005, then New York Fed President Timothy Geithner summoned representatives of 14 of the world’s largest banks, expressing concerns about substantial backlogs in the documentation of credit derivatives. He asked the banks to clear up 80% of the backlog within a year. One report concerning Geithner’s concerns stated: “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.”⁵⁸

Geithner also asked the banks “to form a clearing house for trillions of dollars in complicated derivatives contracts.”⁵⁹ Within a year the banks were able to claim that 94% of the backlog in credit derivatives had been erased.⁶⁰ However, Geithner’s call for the development of a clearing mechanism was not adopted prior to the 2008 meltdown.⁶¹

The swaps dealers’ self study organization – CRMPG – also issued two reports in July 2005 and July 2008, making it clear that there were internal concerns about the viability of the credit derivative market. The former report highlighted problems in the trading of those OTC derivatives, including the frequent assignment to institutions not part of the original deal that made it hard to know who the CDS counterparties were, especially in an era of poor transaction documentation.⁶² The 2005 report also sounded the ominous note that the financial services industry “has very limited experience with settling large numbers of transactions” following a significant credit default.⁶³ The 2008 CRMPG report expressed sufficient concern about credit derivative settlement processes that it “urge[d] swift industry action to create a clearinghouse for

⁵⁷ Peter S. Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?pagewanted=all> (last visited on June 26, 2010).

⁵⁸ *N.Y. Fed Hails Banks’ Progress In addressing Credit Derivatives Issues*, 37 Sec. Reg. & L. Rep. [No. 41, at 1713] (Oct. 17, 2005).

⁵⁹ Robert Lenzner, *Geithner Gets It Right*, FORBES, June 13, 2008, available at http://www.forbes.com/2008/06/13/geithner-banks-fed-oped-cx_rl_0613croesus.html; Yalman Onaran and Michael McKee, *In Geithner We Trust Eludes Treasury as Market Fails to Recover*, BLOOMBERG, Feb. 25, 2009, available at <http://www.bloomberg.com/apps/news?pid=washingtonstory&sid=aLhs5Byln00k>.

⁶⁰ See A RETROSPECTIVE OF ISDA’S ACTIVITIES 2006-2007 5, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

⁶¹ See Onaran and McKee, *supra* note 56.

⁶² See COUNTERPARTY RISK MANAGEMENT POLICY GROUP (CRMPG) II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE (2005), available at <http://www.crmppolicygroup.org/crmppg2/docs/CRMPG-II.pdf>.

⁶³ *Id.* at 113.

OTC derivatives, *starting with CDS.*”⁶⁴ This was certainly an internal industry acknowledgement that all was not well with the CDS market at that time.

How CDS Were Used to Undermine the Subprime Market. I know that this Commission has already studied with care the securitization process as it related to the meltdown. What must be understood now is the manner in which the CDS market heightened substantially risks posed by securitization. In brief, the securitization of subprime mortgage loans evolved to embed simple mortgage backed securities (“MBS”) within highly complex collateralized debt obligations (“CDOs”). As this Commission well knows, these CDOs constituted the pulling together and dissection into “tranches” of huge numbers of MBS, theoretically designed to diversify and offer gradations of risk to those who wished to invest in subprime mortgages.

However, investors became unmoored from the essential risk underlying loans to non-credit worthy individuals by the continuous reframing of the form of risk (*e.g.*, from subprime mortgages to MBS to CDOs); the false assurances given by credit rating agencies that were misleadingly high evaluations of the CDOs; and, most importantly, by the purported “insurance” offered on CDOs in the form of CDSs as a seeming safety net to these risky investments.

How CDS Worked. The CDS “swap” was the exchange by one counterparty of a “premium” for the other counterparty’s “guarantee” of the financial viability of a CDO. While CDSs have all the hallmarks of insurance, issuers of CDSs in the insurance industry, specially the bond insurers (“monolines”) enticed into underwriting CDS, were urged by swaps dealers not to refer to it as “insurance” out of a fear that CDSs would be subject to insurance regulation by state insurance commissioners, which would have included, *inter alia*, strict capital adequacy requirements.⁶⁵ By using the term “swaps,” CDSs fell into the regulatory “blackhole” afforded by the CFMA’s “swaps” exclusion (Section 2 (g)) because no federal agency had direct supervision over, or even advance knowledge of, what went on in the private, bilateral world of “swaps.”

The CFMA Eliminated All Fail Safes for CDS. Accordingly, all of the “fail safes” that apply to the regulated equities market and that had applied to the regulated futures markets were, by virtue of the CFMA, turned off at the time of the meltdown. There were no clearing requirements to ensure that CDS commitments were adequately capitalized. There were no exchange trading requirements, which would have allowed the market to regularly and transparently price these assets; rather than leaving such pricing to the highly contentious mathematical algorithms that constitute the disputatious mark to model system of pricing.

There were also no recordkeeping and reporting requirements, the latter of which might have, in and of themselves, sent signals to prudential and market regulators that systemically

⁶⁴ See CRMPG III, CONTAINING SYSTEMIC RISK: THE ROAD TO REFORM 1 (2008), available at <http://www.crmpolicygroup.org/docs/CRMPG-III.pdf>.

⁶⁵ *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm., 110th Cong.* (October 14, 2008) (opening statement of Eric Dinallo, Superintendent, and New York State Insurance Dept.) (stating “We engaged in the ultimate moral hazard... no one owned the downside of their underwriting decisions, because the banks passed it to the Wall Street, that securitized it; then investors bought it in the form of CDOs; and then they took out CDSs. And nowhere in that chain did anyone say, you must own that risk.”) available at <http://www.gpo.gov/fdsys/pkg/CHRG-110shrg838/html/CHRG-110shrg838.htm> .

risky institutions were without adequate capital underwriting trillions of dollars of insurance while wholly underpricing the risk of the underwriting.

The lack of recordkeeping and reporting also prevented fraud enforcement – had fraud enforcement itself not been banned for CDS by the CFMA. The lack of reporting also blinded regulators to the scope of the problems caused by underfunded CDS commitments, leaving them guessing as to the reality of the situation and adopting (perhaps correctly) a worst case scenario of defaults and resulting systemic risk.

Again, because CDS were deemed neither insurance nor an instrument otherwise regulated by the federal government, issuers were not required to set aside adequate capital reserves to stand behind the guarantee of CDOs.

The Motivations for Underwriting Subprime CDS. The issuers of CDSs were almost certainly beguiled by the utopian view (supported by ill considered mathematical algorithms) that housing prices would always go up. They believed that even a borrower who could not afford a mortgage at initial closing would soon be able to extract the constantly appreciating value in the residence to refinance and pay mortgage obligations. Under this utopian view, the writing of a CDS was deemed to be “risk free” with a goal of writing as many CDSs as possible to develop what was considered to be the huge risk free cash flow from the CDS “premiums.” Unfortunately, when housing prices collapsed and defaults were triggered, it was clear that the premiums vastly underpriced the huge risk undertaken.

CDS Encourage Subprime Investments. Again, because there was thought to be insurance to place a floor under what certainly must have seemed to some investors a risky bet on the success of mortgages to non-credit worthy lenders, that false confidence certainly fed the flames of investment in the subprime securitization process. In other words, each investment in a CDO was thought to be protected by insurance on that investment. Accordingly, there was a higher demand for the mortgages and mortgage backed securities that fed the CDO. Because of the lack of transparency, regulators could not observe the phenomena that the MDS CDO frenzy was sparked by insurance that was not properly capitalized.

Naked CDS Encourages Widespread Betting on the Subprime Market. To make matters worse, CDSs were deemed to be so risk-free (and so much in demand) that financial institutions began to write “naked” CDSs, *i.e.*, offering the guarantee against default to investors who had *no* risk in any underlying mortgage backed instruments or CDOs. (Under state insurance law, this would be considered insuring someone else’s risk, which is flatly banned.⁶⁶) Naked CDSs provided a method to “short” the mortgage lending market without any exposure to its risks. In other words, these instruments allowed speculators to place the perfectly logical bet for little consideration (*i.e.*, the relatively small premium) that those who could not afford mortgages would not pay them off.

The recent suit by the SEC against Goldman Sachs is highly instructive on this point even leaving to the side the question whether the bank committed fraud as the SEC alleges. The

⁶⁶ See Arthur Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. INS. L.J. 241, 251-52 (2008).

hedge fund manager, John Paulson, worked with Goldman Sachs (who according to the SEC charged Paulson a \$15 million fee) to select among a series of CDOs those tranches deemed most likely to lose value. Paulson did not own those tranches. With Goldman's help, Paulson just wanted to find someone who would take the opposite end of his bet, *i.e.* an institution that was prepared to bet that the tranches in question – not owned by any party to the bet – would survive by giving Paulson insurance against those tranches' failure. These instruments are called synthetic CDOs, which are composed of a series of naked CDS on the tranches identified.

Again, leaving aside the question whether Goldman defrauded institutions into taking the opposite side of the Paulson bet, the concept of lawful betting of billions of dollars on the question whether a homeowner would default on a mortgage that was not owned by either party, has had a profound effect on the American public and taxpayers, who became the lender of last resort to make the winning betters whole.

The Taxpayer Is the Lender of Last Resort to the Bankrupt CDS Casino. In this case, Paulson won about \$1 billion betting that homeowners would default while his counterparties lost the same amount taking the opposite side of the bet. Because these OTC transactions were not properly capitalized, the losing counterparties would have collapsed under the strain of paying these bets; and, because of interconnectedness among financial institutions, any single collapse of a major financial institution would have destabilized the world wide economy. Only the intervention of taxpayers as the lender of last resort, stemmed the onset of a worldwide Depression.

The financial media is filled with reports that the SEC will be bringing further actions similar to the Goldman case premised upon synthetic CDOs; and private parties are readying similar cases pursuant to the private rights of action clauses within the securities law.⁶⁷

The analysis surrounding this subject estimates that there may have been three to four times as many “naked” CDS instruments extant at the time of the meltdown than CDSs guaranteeing actual risk.⁶⁸ This means that to the extent the guarantor of a CDS (*e.g.*, AIG) had to be rescued by the U.S. taxpayer, the chances were very high that the “bail out” was of failed naked CDS bets that mortgages would be paid. (Of course, prominent Members of Congress have maintained that the holders of bets that mortgages would fail have formed a strong political constituency against the “rescue” of subprime borrowers through the adjustment of mortgages to keep homeowners from defaulting.⁶⁹)

⁶⁷ See, *e.g.*, David Holmes, *AIG eyes action vs Goldman over CDOs: report*, Reuters, April 20, 2010, available at <http://www.reuters.com/article/idUSTRE63J13E20100420> (last visited on June 24, 2010).

⁶⁸ *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm., 110th Cong. 3* (October 14, 2008) (written testimony of Eric Dinallo, Superintendent, New York State Insurance Dept.) available at <http://www.ins.state.ny.us/speeches/pdf/sp0810141.pdf>; Dawn Kopecki and Shannon D. Harrington, *Banning ‘Naked’ Default Swaps May Raise Corporate Funding Costs*, July 24, 2009 available at <http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk>.

⁶⁹ See Ryan Grim, *Dick Durbin: Banks ‘Frankly Own The Place’*, HUFFINGTON POST, April 29, 2009, available at http://www.huffingtonpost.com/2009/04/29/dick-durbin-banks-frankly_n_193010.html (referring to rising number of Senate Democrats' opposition to cramdown).

The fact that “naked” CDS and “synthetic” CDOs were nothing more than “bets” on the viability of the subprime market also demonstrates the importance of the CFMA expressly preempting state gaming and anti-bucket shop laws.⁷⁰ Had those laws not been preempted, it is almost certain that at least some states would have banned these investments as unlicensed gambling or illegal bucket shops. An action of this sort by even a single state would have disrupted the “naked” CDS market throughout the country.

Moreover, doubtless because Eric Dinallo, in his then capacity as New York Insurance Superintendent, seriously considered regulating CDS as insurance⁷¹ and because the National Council of Insurance Legislators are working on a model code to regulate CDS as insurance,⁷² the financial reform legislation now working its way through Congress would also preempt state insurance law as it would apply to swaps that are neither cleared or exchange traded.⁷³

Conclusions to Be Drawn about Subprime CDS. It is now common knowledge that:

1. Underwriters of CDSs did not have adequate capital to pay off guarantees as housing prices plummeted, thereby defying the supposed “risk free” nature of issuing huge guarantees for the small premiums that were paid.
2. Because CDS were private and bilateral arrangements for which there is no meaningful “reporting” to federal regulators, the triggering of the obligations there under often came as a “surprise” to both the financial community and government regulators.
3. As the housing market worsened, new CDS obligations were unexpectedly triggered, creating heightened uncertainty about the viability of financial institutions who had, or may have had, issued these instruments, thereby leading to the tightening of credit. No institution could be trusted because there was no transparency as to which institutions held toxic CDS.
4. The issuance of “naked” CDS increases exponentially the obligations of the CDS underwriters in that every time a subprime mortgage defaults there is both the real financial loss and the additional exponential loss derived from failed bets.
5. The securitization structure (including CDS) is present not only in the subprime mortgage market, but in the prime mortgage market, as well as in commercial real estate, credit card debt, and auto and student loans. As of this writing, the financial media is filled with concerns that forfeitures in commercial real estate market will worsen sufficiently, thereby triggering CDSs and naked CDSs for which will almost certainly be

⁷⁰ DERIVATIVES REGULATION § 4.04[11] at 975 (2004) (referencing 7 U.S.C. § 16(e)(2)).

⁷¹ New York State Insurance Dept., Recognizing Progress By Federal Government In Developing Oversight Framework For Credit Default Swaps, New York Will Stay Plan To Regulate Some Credit Default Swaps, press release, November 20, 2008 (“Dinallo announced that New York had determined that some credit default swaps were subject to regulation under state insurance law and that the New York State Insurance Department would begin to regulate them on January 1, 2009.”).

⁷² See Credit Default Insurance Model Legislation, National Conference of Insurance Legislators, Nov. 22, 2009, available at <http://www.ncoil.org/HomePage/2010/03212010CDIModel.pdf>.

⁷³ Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 722(b) (2010), available at http://financialservices.house.gov/pdf/AYO10F74_xml.pdf.

insufficient capital to pay the guarantees. This restarts the downward cycle that drove the country into recession to begin with.⁷⁴

Interconnectedness: The Systemic Risk Derived from All Types of Swaps

Swaps Other Than CDS Have Caused Serious Financial Dislocations. Moreover, while CDSs and synthetic CDOs almost certainly lit the fuse that led to the recent explosive financial destabilization, the remainder of the OTC market has historically led to other destabilizing events in the economy. These include the recent energy and food commodity bubble,⁷⁵ the near failure of LTCM in 1998, the Bankers Trust scandal and the Orange Country bankruptcy of 1994, and now the causative factor of the European sovereign debt crisis (cross currency swaps masking the full extent of sovereign debt).⁷⁶

Unregulated OTC Derivatives of All Kinds Cause “Too Big To Fail.” However, even if looking only at the financial crisis which is now the focus of this Commission’s mandate, the remainder of the unregulated OTC derivatives market was central to the crisis’ causation. That is because the remainder of the OTC derivative market relates directly to the interconnectedness that made large financial institutions “too big to fail;” and the prevention of a cascading collapse of the financial system therefore required calling upon the American taxpayer to bail out many of those huge financial entities.

The Lehman Bankruptcy. As now can be seen from the Lehman bankruptcy proceedings, Lehman was a counterparty or guarantor of over 930,000 OTC derivatives.⁷⁷ To the extent that these contracts did not involve CDS, they certainly involved unregulated interest rate, currency, foreign exchange, and energy swaps.

The Lehman liquidators are now embarked in a huge battle with Lehman’s OTC derivative counterparties, claiming that those counterparties have greatly exaggerated the value of amounts owed by Lehman pursuant to those derivatives. The liquidators have just filed a law suit against Nomura, which has filed \$1 billion in counterparty claims against the Lehman estate.

⁷⁴ See, e.g., Michael J. de la Merced, *Heavy Debt Bankrupts Mall Owner*, N.Y. TIMES, April 16, 2009, available at <http://www.nytimes.com/2009/04/17/business/economy/17mall.html> (last visited February 23, 2010); Scott S. Powell and David Lowry, *Commercial real estate crisis threatens recovery*, ATL. J. CONST., Sept. 15, 2009, available at <http://www.ajc.com/opinion/commercial-real-estate-crisis-139350.html> (last visited February 23, 2010).

⁷⁵ See generally Written Testimony of Professor Michael Greenberger, *Hearing Before the House Energy and Commerce Subcommittee on Oversight and Investigations Regarding Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation? – Part II* (2008), available at http://michaelgreenberger.com/files/June_23_2008_testimony.pdf; Written Testimony of Professor Michael Greenberger, *Hearing before the Commodity Futures Trading Commission on Excessive Speculation: Position Limits and Exemptions* (2009), available at http://michaelgreenberger.com/files/CFTC_AFR_Sign_On_Testimony_August_3.pdf.

⁷⁶ Louise Story, Landon Thomas Jr. & Nelson D. Schwartz, *Wall St. Helped to Mask Debt Fueling Europe’s Crisis*, N.Y. TIMES, Feb. 13, 2010, available at <http://www.nytimes.com/2010/02/14/business/global/14debt.html> (last visited on June 27, 2010).

⁷⁷ GuyLaine Charles, *OTC Derivative Contracts in Bankruptcy: The Lehman Experience*, N.Y. BUS. L. J. §1:14 (Spring 2009), available at <http://www.nysba.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=30052> (last visited on June 27, 2010).

Lehman asserts that Nomura's claims would "wrongfully extract hundreds of millions of dollars" and that "Nomura filed egregious derivative claims against the estate that grossly overstate actual damages." . . . About 6,000 derivatives claims –totaling \$60 bn in losses – were filed against Lehman's US estate . . . , including claims from about 40 of the largest US banks."⁷⁸

Bear Stearns Interconnectedness. As further evidence of the interconnectedness of OTC derivative counterparties, on April 3, 2008, New York Fed President Timothy Geithner explained after the Bear Stearns collapse: "The sudden discovery by Bear's derivative counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocations in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to replicate those positions in already fragile markets."⁷⁹ Citing this quote, Warren Buffet concluded: "This is Fed speak for 'We stepped in to avoid a financial chain reaction of unpredictable magnitude.' In my opinion, the Fed was right to do so."⁸⁰

AIG Interconnectedness. Of course, it was the very failure of Lehman, and the cascading adverse and substantial impacts its bankruptcy has caused, that led the Federal Reserve and the Treasury to alter course on the day after Lehman's failure, and to prevent AIG's bankruptcy and then to recommend the TARP bailout. Those actions revealed to the world the correlation between interconnectedness of unregulated OTC swaps transactions and the too big to fail doctrine.

Again, the great portion of the taxpayer funds that went into the front door of AIG to "save it" went out the back door as payments to its derivatives counterparties. As the recent report of the Congressional Oversight Panel ("COP") on the AIG bailout makes clear, billions of the taxpayer bailout went 100 cents on the dollar to AIG's derivatives counterparties.⁸¹ In this regard, COP observed as to AIG's derivatives book:

"In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors. But rather than sharing the pain among AIG's creditors, the government instead shifted those costs in full onto taxpayers. The result was the government backed up the entire derivatives market, as if high-profit, high-risk trading deserved the same taxpayer backstop as savings deposits and checking accounts. Every counterparty — from pension funds for retired workers and individual insurance policies, to sophisticated investors and other financial institutions — received exactly the same deal: a complete rescue at taxpayer expense."⁸²

⁷⁸ Megan Murphy & Anousha Sakoui, *Lehman sues Nomura over derivatives' claims*, FINANCIAL TIMES, April 23, 2010, available at <http://lehmanlotto.blogspot.com/2010/04/nomura-sued-over-lehman-claims.html>.

⁷⁹ Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc. to the Shareholders of Berkshire Hathaway Inc. (Feb. 27, 2009), available at <http://www.berkshirehathaway.com/letters/2008ltr.pdf>.

⁸⁰ *Id.*

⁸¹ Congressional Oversight Panel, *June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy*, at 286 (June 10, 2010), available at <http://cop.senate.gov/documents/cop-061010-report.pdf> (last visited on June 27, 2010).

⁸² *Id.* at 9.

The Interconnectedness Problems of Resolution Authority. Of course, the financial regulation reform bill's Title II creates a resolution authority, which allows these complicated questions of the orderly unwinding of a too big to fail institution to be handled administratively rather than in a bankruptcy proceeding. However, as Robert Johnson has recently made clear, the unwinding of the obligations of OTC counterparties may, in the absence of OTC derivative reform, be far too complex whether it is done by banking regulators or by a court. Johnson has concluded:

“[W]hen a [too big to fail institution] is in trouble –and there are substantial holdings of complex and opaque derivatives on the balance sheets of all [such] firms – resolution authorities have difficulty unraveling web of exposures and valuing them properly. . . Unfortunately, it is easy to understand why resolution authorities could be induced to forebear rather than resolve an [too big to fail institution] when they have no clarity about its structure and patterns of exposures. In such a circumstance, it may be easier to incur the risk that the insolvent [firm's] balance sheet should continue to deteriorate. . . .”⁸³

All Swaps Are Masked By Opaque Accounting Principles. A final reason all derivatives – not just credit derivatives – played a role in the onset of the crisis is that they were by virtue of swaps dealer lobbying never properly accounted for on balance sheets. Because of a major lobbying effort by ISDA,

“banks and corporations that trade swaps do not play by the same rules as other individuals and businesses. Banks are permitted to exclude their full exposure to swaps from their financial statements and instead report only the “fair value” changes in those swaps over time. Such reporting is like an individual reporting only the change in their debt balances, instead of reporting the debts themselves.”⁸⁴

Thus, prior to the meltdown swaps of all kinds were masked by a double barrier of opacity, *i.e.*, not only were they private and bilateral, but they were even hidden on the balance sheets of those institutions most likely to suffer from their adverse impact. This kind of balance sheet opacity blinded regulators and market observers from the explosive and toxic nature of the contractual obligations embedded in swaps. And, when the crisis became full blown in September 2008, this opacity led both the extenders of credit and policy makers to fear the worst. As a result bank lending froze up, causing the credit crisis.

⁸³ Robert Johnson, *Credible Resolution – What It Takes to End Too Big to Fail*, in MAKE MARKETS BE MARKETS, 123 (Roosevelt Institute, 2010).

⁸⁴ Frank Partnoy and Lynn E. Turner, *Bring Transparency to Off-Balance Sheet Accounting*, in MAKE MARKETS BE MARKETS, 88 (Roosevelt Institute, 2010).

Conclusion

By removing the multi-trillion dollar swaps market from the traditional norms of market regulation, a highly speculative derivative bubble was created that was opaque to federal regulators and market observers alike. By removing all forms of ensuring the normal capital adequacy protections of market regulation, the swaps market permitted trillions of dollars of financial commitments to be made with no assurance that those commitments could be fulfilled beyond the highly illusory AAA ratings of the counterparties in question.

Had the norms of market regulation been applicable, these swaps transactions would have been adequately capitalized by traditional clearing norms; and the dangers building up in these markets would otherwise have been observable by the transparency and price discipline that accompanies exchange trading.

While the poorly capitalized underwriting of CDS and naked CDS triggered the meltdown, the crisis was further aggravated by the opaque interconnectedness of large financial institutions emanating from interest rate, currency, foreign exchange and energy swaps.

Because there was no road map outlining interdependency of those financial transactions, the worst was feared in the wake of the Bear Stearns, Lehman, AIG, and Merrill dysfunctions. Institutions became too big to fail because of these uncharted and feared interdependencies; and the fear that unwinding of these institutions (as proven in the Lehman bankruptcy) would be hampered by the lack of reliable pricing of the instruments in question.

The darkness of this huge multi-trillion dollar unregulated market not only caused, but substantially aggravated, the financial crisis. And, the American taxpayer funded the bailouts and rescued the economy from Depression. The banks are now stronger than ever. The taxpayer, however, is burdened by high unemployment, job insecurity, depleted pensions, and little access to credit. We are depending on this Commission to identify correctly the malpractices to ensure that a fiasco of this nature never happens again.