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Do End-Users Get the Best of Both worlds?—Title VII of Dodd–Frank and the End-User Exception

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Do End-Users Get the Best of Both Worlds?—Title VII of Dodd–Frank and the End-User Exception

Carney Simpson*

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I. Introduction

“Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”¹ Warren Buffet made this statement to Berkshire shareholders in 2002.² The potential threat of the derivatives market was known then and became real in 2008. Now the government is taking action to control it.

The financial crisis of 2008 was one of the largest in American history and almost led to the collapse of the U.S. financial system.³ Factors likely contributing to the crisis include the repeal of the Glass-Steagall Act, the influx of foreign money, the popularity of hedge funds and private equity, and the rise of mortgage-backed securities.⁴ Although the financial crisis of 2008 had numerous causes, the over-the-counter (OTC) derivative market was one of the most noted.⁵

1. Letter from Warren Buffet, Chairman of Bd., Berkshire Hathaway, Inc., to S'holder, Berkshire Hathaway, Inc. (Feb. 23, 2003) (on file with the Washington and Lee Law Review).

2. See Paul B. Farrell, *Derivatives the New 'Ticking Bomb' Buffet and Gross Warn: \$516 Trillion Bubble is a Disaster Waiting to Happen*, MARKETWATCH (Mar. 10, 2008), <http://www.marketwatch.com/story/derivatives-are-the-new-ticking-time-bomb> (last visited Sept. 18, 2012) (discussing how the derivatives market grew from \$100 trillion in 2002, at the time Warren Buffett's letter was written, to \$516 trillion in 2007, the year prior to the financial crisis) (on file with the Washington and Lee Law Review).

3. See Ben S. Bernanke, Chairman, Fed. Reserve, Speech at Morehouse College: Four Questions About the Financial Crisis (April 14, 2009), <http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm> (last visited Sept. 27, 2012) (on file with the Washington and Lee Law Review).

4. See William Spencer Topham, *Re-regulating "Financial Weapons of Mass Destruction," Observations on Repealing the Commodity Futures Modernization Act and Future Derivative Regulation*, 47 WILLIAMETTE L. REV. 133, 135 (2010) (listing suspected causes of the 2008 financial crisis).

5. See ALAN N. RECHTSCHAFFEN, CAPITAL MARKETS, DERIVATIVES AND THE LAW, 173–74 (2009) (explaining the risks associated with credit derivatives that posed many issues for AIG in 2008, ultimately leading to the corporation's government bailout); Jeremy Gogel, *Shifting Risk to the Dumbest Guy in the Room—Derivatives Regulation After the Wall Street Reform and Consumer Protection Act*, 11 J. BUS. & SEC. L. 1, 30–31 (2010) (addressing the role that the derivatives market, especially credit default swaps, played in the 2008 financial crisis); Zachary J. Gubler, *The Financial Innovation Process: Theory and Application*, 36 DEL. J. CORP. L. 55, 87–89 (2011) (explaining that OTC derivatives contributed to the financial crisis by “laying the foundation for faulty risk modeling and by contributing to bank-like runs”).

Some say that the OTC market's influence on the financial crisis was a result of the market's large financial volume and a lack of corresponding government regulation.⁶ As of July 2010, the OTC derivatives market had a notional value of approximately \$300 trillion in the United States.⁷ This amount is roughly twenty times the size of the American economy.⁸ The notional amount is a way in which derivatives are priced, but it does not consider the risk involved.⁹ This risk can be much smaller or larger than the notional contract amount.¹⁰ Because this market is large and rapidly growing, regulation is necessary but will never completely eliminate the risks the market poses because of the complexity of the contracts and the rate of innovation in the market.¹¹

The widespread use of OTC derivatives for speculative purposes exposes market participants to systemic risk.¹² Systemic risk arises when investors hold highly leveraged positions that could trigger a crisis like that of 2008.¹³ Due to the number of

6. See Lynn A. Stout, *How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another 1* (UCLA Sch. of Law, Law-Econ Research, Paper No. 09-13) [hereinafter Stout, *Deregulating Derivatives*] (theorizing that the banking system failure in 2008 was caused primarily by the deregulation of the derivatives market in 2000); see also *infra* Part IV.A (providing a background on past derivatives regulation and why the government chose not to act until the 2008 crisis).

7. See *The Role of Derivatives in the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm'n*, 2 (July 1, 2010) (statement of Gary Gensler, Chairman, Commodity Futures Trading Comm'n) [hereinafter Gary Gensler Testimony].

8. *Id.*

9. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEMS 35 (1994) [hereinafter GAO REPORT].

10. See *id.*

11. See Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 1013-14 (explaining how the unprecedented rate of financial innovation in the OTC market is largely due to persons with quantitative or physical science backgrounds playing vital roles in pricing the contracts).

12. See Laurin C. Ariail, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: The Impact of Dodd-Frank on End-Users Hedging Commercial Risk in Over-the-Counter Derivatives Markets*, 15 N.C. BANKING INST. 175, 179-80 (2011) (discussing the risks that the OTC derivatives market poses to market participants and the financial economy as a whole).

13. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of*

OTC contracts and their interconnection with other trading instruments, a small market shift in the value of an OTC derivative could lead to a major international liquidity problem.¹⁴ OTC derivatives enhance systemic risk dramatically because they lack transparency.¹⁵ Improving transparency in the OTC market is precisely why regulation and disclosure are necessary for all participants.

To protect the economy from systemic risk, Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act¹⁶ (Dodd–Frank) in an effort to increase transparency, regulate pricing in the derivatives market, and, most importantly, minimize the risk to the American people.¹⁷ Title VII of Dodd–Frank proposes guidelines that the Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC) are required to follow when promulgating regulations for the derivatives market.¹⁸ One of the most important changes Dodd–Frank requires is the formulation of a clearing organization for OTC derivatives, particularly swaps.¹⁹

The regulation for clearing organizations requires market participants to set initial margin requirements, post or recover collateral at the end of each day, and provide certain disclosures that were previously not required.²⁰ This only applies to “swap

Credit Derivatives, 75 U. CINN. L. REV. 1019, 1040 (2010) (discussing how the size of the credit default swap market could cause a ripple effect throughout financial markets even when only one small thing goes awry).

14. *See id.*

15. *See* Ariail, *supra* note 12, at 179–80 (indicating that the opaqueness of the market is a major risk associated with the OTC market).

16. Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 711–774, 124 Stat. 1376, 1641–1802 [hereinafter Dodd–Frank].

17. *See Testimony Concerning the Over-the-Counter Derivatives Markets Act of 2009: Hearing on H.R. 4173 Before the H. Comm. on Agric.*, 111th Cong. 164 (Sept. 22, 2009) (statement of Mary Schapiro, Chairman, Sec. & Exch. Comm’n) [hereinafter *Schapiro*].

18. Dodd–Frank § 717.

19. *Id.* § 725. This section pertains specifically to CFTC’s jurisdiction over non-security based swaps. *Id.*

20. CFTC General Regulations and Derivatives Clearing Organizations Rule, 17 C.F.R. pts. 1 & 39 (2010).

dealers” and “major swap participants.”²¹ These definitions apply to participants who hold large positions that would create substantial counterparty exposure and increase the threat of systemic risk.²²

When defining these terms, the CFTC examined the appropriate risk factors associated with these users and the role they allegedly played in the 2008 financial crisis.²³ Nonfinancial corporations who participate in the market, commonly classified as “end-users,” are not subject to the mandatory clearing of swaps.²⁴ An end-user is a corporation that utilizes the OTC market to enter into customized contracts that hedge an already exposed risk, such as fluctuation in interest rates or foreign currency.²⁵ A survey of the world’s largest 500 companies revealed that 94% of them use the derivatives market as end-users to manage and hedge business risk.²⁶ Thus, a large number of market participants are not subject to regulation.

The end-user exception defines end-users narrowly and provides minimal regulation requirements.²⁷ It applies to a nonfinancial entity that is a participant and uses swaps to hedge or mitigate commercial risk.²⁸ The only real requirement for end-users is to elect the exception and then notify the Commission as to how it will generally meet its financial obligation.²⁹

21. *Id.* 77 Fed. Reg. 30596 (May 23, 2012) (to be codified at 17 C.F.R. pt. 1) provides a definition of “swap dealer,” “security-based swap dealer,” “major swap participant,” and “major security-based swap participant.”

22. *See* 156 Cong. Rec. S5907 (daily ed. July 15, 2010) (statement of Sen. Blanche Lincoln) (stating that when defining major swap participant, the CFTC should consider the risk factors associated with holding a substantial position in the OTC market).

23. *See id.*

24. *See* 17 C.F.R. pt. 39 (2012).

25. *See infra* notes 83–87 and accompanying text (introducing the corporate end-user and its role in the OTC market).

26. *See ISDA Survey Results: Derivatives Usage by the World’s Largest Companies*, ISDA NEWS RELEASE (Apr. 22, 2009), <http://www2.isda.org/functional-areas/research/surveys/end-user-surveys> (last visited Sept. 27, 2012) [hereinafter ISDA NEWS RELEASE] (on file with the Washington and Lee Law Review).

27. *See* 17 C.F.R. pt. 39 (2012).

28. *Id.*

29. *Id.*; *see infra* Part V.A for an in-depth description of the end-user exception.

Commercial end-users disfavor the narrow interpretation and the minimal level of regulation that it imposes.³⁰ Commercial end-users wanted the CFTC to broadly cast the definition of end-user to include affiliate companies who utilize the market and, further, allow commercial end-users to hedge risk in the OTC market with minimal transaction costs.³¹ This Note examines the CFTC's rule pertaining to the end-user exception and analyzes whether the CFTC's narrow interpretation is the most beneficial approach. This Note proposes that the CFTC broaden the end-user definition to exempt more users, such as small banks and corporate affiliates.³² But to broaden the exception, this Note argues that regulators must impose stricter disclosure and reporting requirements to monitor the market for abuse of the exception. The end-user exemption's aim is to maintain low transaction costs, but regulators must monitor closely the potential abuse of this exception. The risk is that participants could disguise speculative uses of the market in the form of bona-fide hedging.

This Note emphasizes the CFTC's definition of end-user because the CFTC has jurisdiction over all commodity-based swaps (including interest rate swaps), options, and futures.³³ Based on statistics from the Bank of International Settlements, interest rate contracts on the OTC market comprised 78% of all

30. Letter from Mark Magnesen, Sr. Vice President & Treasurer, Kraft Foods Inc., to David A. Stawick, Sec'y of the Comm'n, CFTC (Feb. 11, 2011) [hereinafter Kraft Foods Letter] (providing commentary to proposed rule, 75 Fed. Reg. 80474, in favor of a broad end-user exception and less regulation of end-users) (on file with the Washington and Lee Law Review).

31. *See id.* at 6–7 (addressing the particular concerns Kraft Foods, Inc. has pertaining to the definition of the end-user).

32. *See id.* at 2 (discussing how Kraft's affiliate corporations utilize the OTC derivative market as agents for Kraft and Kraft's subsidiary companies to hedge exposed market risk). Kraft has a complex structure that calls for two affiliate companies to enter into swap transactions with Kraft, its subsidiary corporations, and at times, swap dealers. *Id.* Due to the affiliate corporations' active participation in the OTC market, Kraft submitted a comment to the CFTC end-user exception to guarantee that the affiliate's participation and use would fall within the definition of end-user. *See id.* at 4–5.

33. *See* 156 Cong. Rec. 105, S5293 (daily ed. July 15, 2010) (statement of Sen. Blanche Lincoln) (stating that non-narrow-based security index swaps and credit default swaps may be the only swaps that will fall within the jurisdiction of the SEC).

outstanding contracts on the market in June 2011.³⁴ Because interest rate contracts are highly traded among OTC market participants, especially end-users, this Note examines how the CFTC approaches the regulation.³⁵

Part II of this Note provides an overview of the OTC derivatives market. It introduces the different kinds of contracts traded in the OTC market and elaborates on the type of risks associated with the OTC market. Part III examines who qualifies as an end-user and how they utilize the market. Part IV gives a brief history of past regulation in the OTC derivative market. It also introduces Title VII of Dodd–Frank and the requirements it imposes on the OTC market, especially end-users.

Although it is vital that commercial end-users have the ability to hedge risk with individualized contracts at minimized costs, a narrow exception with minimal regulation is not in the American public's best interest. Part V introduces alternative approaches to regulating OTC derivatives. This Note argues that the regulation should exempt end-users, but that the current requirements of end-users are not sufficient to meet Title VII's aims to promote transparency in the OTC market and to protect the American public from systemic risk. This Note tackles the question of how broad to make the end-user definition and how to then regulate those falling within the definition. This Note argues for a broader definition to accommodate the number of users who cannot afford to participate in the market if subjected to mandatory clearing requirements.³⁶

Part VI proposes that end-users should comply with stringent disclosure and reporting requirements in order not to exacerbate another financial crisis. The proposed disclosure model mirrors the ISDA's Master Agreement, a standard form agreement already used by a number of market participants.³⁷

34. See Bank for Int'l Settlements, *Semiannual OTC Derivatives Statistics at End-June 2011*, <http://www.bis.org/statistics/derstats.htm> (last visited Sept. 27, 2012) (providing a table of the amounts outstanding of OTC derivatives by instrument) (on file with the Washington and Lee Law Review).

35. See *ISDA End-User Survey: Interest Rate Swaps* (Oct. 2010), <http://www2.isda.org/functional-areas/research/surveys/end-user-surveys> (last visited Sept. 27, 2012) [hereinafter *ISDA Survey: Interest Rate Swaps*] (on file with the Washington and Lee Law Review).

36. See Kraft Foods Letter, *supra* note 30.

37. See *infra* notes 131–34 and accompanying text (introducing the ISDA

The goal is to strike a balance between a broad end-user exemption and protecting the market from users abusing this exception through speculation and highly leveraged bets. This Note argues that such a balance is achievable so long as regulators demand more disclosure of end-users, particularly in regard to their ability to meet financial obligations. This will promote transparency and allow regulators to easily monitor abuse of the exception. While this Note acknowledges that the rapidly changing face of financial innovation in the OTC derivatives market makes it difficult for regulators to implement an efficient regulatory scheme, this Note's proposal could nevertheless work by adapting disclosure requirements to changes in financial innovation.

II. Over-the-Counter Derivative Market

A. Market Overview

A derivative contract is “a bilateral contract or payments exchange agreement whose value derives . . . from the value of an underlying asset or underlying reference rate or index.”³⁸ Derivatives are traded in two kinds of markets: exchanges and OTC markets.³⁹ This Note focuses on the OTC market where contracts are bilaterally negotiated collateral agreements with flexible terms that mature over time.⁴⁰

The OTC market consists of privately negotiated and traded agreements.⁴¹ These market characteristics enable market participants to tailor derivative contracts to their specific needs.⁴²

Master Agreement).

38. See RECHTSCHAFFEN, *supra* note 5, at 159 (citing Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1275 (S.D. Ohio 1996)).

39. Randall Dodd, *The Structure of OTC Derivatives Markets*, 9 THE FINANCIER 1, 1–4 (2002).

40. See RECHTSCHAFFEN, *supra* note 5, at 163 (listing the main points of how exchange-traded and OTC markets differ).

41. See *id.* at 162–63 (discussing the difference between derivative exchange markets, which are designed to eliminate counterparty risk by standardizing contracts, and OTC markets, which increase counterparty risk and illiquidity due to the contracts' individualized terms).

42. See *id.* (describing how the flexibility of OTC contracts enables participants to transact for what they need).

This market appeals to commercial users hedging risk and noncommercial investors speculating in the market to obtain large profits.⁴³ Although derivatives contracts allow participants to obtain large arbitrage profits and hedge exposed risks, they have a potentially large downside.

The resulting losses from Long Term Capital Management's (LTCM) failure in 1998 and the AIG bailout in 2008 revealed this downside.⁴⁴ These failures presented issues of counterparty credit risk.⁴⁵ AIG sold credit derivatives in the OTC market that essentially insured corporate credit.⁴⁶ AIG, a dealer of credit default swaps, was able to undertake a great amount of exposure in the OTC market by selling insurance on the risk of default where the underlying asset was a mortgage-backed security.⁴⁷ Unfortunately, such contracts required large payments to counterparties when the subject of the credit default swap worsened.⁴⁸ With the decrease in credit ratings in 2008 due to the downfall of the economy, AIG became responsible for posting collateral to numerous outstanding credit default swap contracts.⁴⁹ Due to the multiple positions AIG held in credit default swaps, the company could not meet all of the collateral

43. See, e.g., EMILOS AVGOULEAS, *THE MECHANICS AND REGULATION OF MARKET ABUSE* 43 (2005) (listing why the derivatives market is attractive to different users).

44. See RECHTSCHAFFEN, *supra* note 5, at 160–62 (discussing the systemic risk effects of the failure of LTCM, Bear Stearns, and AIG due to their large speculative positions in the OTC markets).

45. See *id.* (describing the effect of one party defaulting on its contract due to failure and shifting the risk to the counterparty). This dislocation of risk has a great impact on the market, and will likely create a ripple effect for the economy as a whole. *Id.* See Gubler, *supra* note 5, at 87–88 (stating that AIG underwrote approximately \$80 billion in notional amount of credit default swaps derived from mortgage-backed securities).

46. See RECHTSCHAFFEN, *supra* note 5, at 173–74 (providing a brief overview of how AIG was able to insure multiple times the value of the outstanding credit of the companies subject to the transaction). Market participants use credit default swaps to transfer credit risk to another party at a set cost. *Id.* at 179.

47. See Gubler, *supra* note 5, at 87–88 (discussing the role of OTC derivatives and AIG in the 2008 financial crisis).

48. See RECHTSCHAFFEN, *supra* note 5, at 173–74.

49. See David A. Skeel & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 165–66 (2012) (providing an overview of the role derivatives played in AIG's bailout).

demands and turned to the government to help meet its obligations, avoiding a worse crisis than the nation was already facing.⁵⁰

Participants in the OTC market, especially major participants and dealers, hold large positions.⁵¹ If one party was to default, the loss endured by the counterparties to all of their derivative contracts could disrupt market functioning.⁵² This fear of disruption is exactly why the government intervened on multiple occasions to bail out financial institutions and related entities.⁵³ While speculation is not normally pertinent to end-users, this Note proposes the idea that minimally regulated end-users could manipulate the exception and speculate while claiming the hedging exemption.⁵⁴ The general problem of distinguishing between hedging and speculation is a difficult task.⁵⁵ In May 2012, JPMorgan Chase lost \$2 billion over a six week period in a trading portfolio used to hedge risks to which the company exposed itself.⁵⁶ This shows how transactions designed to hedge exposed risk could seem like speculation and result in large losses.⁵⁷

50. *See id.* at 166 (stating that the only other alternative for AIG would have been bankruptcy, which would have left the counterparties to the swap transactions with no way to receive collateral payments).

51. *See id.* at 162 (stating that if the Federal Reserve did not facilitate the private sector recapitalization, then counterparties' losses could have been somewhere from \$3 billion to \$5 billion).

52. *See id.*

53. *See id.* at 163–66.

54. *See infra* note 209 and accompanying text (discussing how the lack of disclosure proposed by the end-user exception does not effectively enable regulators to monitor the market for abuse of the exception).

55. *See* Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, 100 COLUM. L. REV. 1096, 1097 (2000) (presenting the question of how to distinguish between allocation of risk and gambling).

56. *See* Dawn Kopecki, Michael J. Moore, & Christine Harper, *JPMorgan Loses \$2 Billion on Unit's 'Egregious Mistakes'* (May 11, 2012), <http://www.bloomberg.com/news/2012-05-11/jpmorgan-loses-2-billion-as-mistakes-trounce-hedges.html> (last visited Sept. 27, 2012) (on file with the Washington and Lee Law Review).

57. *See id.* (“Concern [is] ‘that a large, supposedly sophisticated institution, even something called a ‘hedge’ can contain all kinds of hidden risks that the senior people don’t understand.’”).

Speculation in the derivatives market is a dangerous endeavor because the market exposes investors to a large amount of risk from highly leveraged bets.⁵⁸ By imposing minimal regulation on end-users, transparency in the market is not achieved and bad actors can more easily hide trading activities from regulators.⁵⁹ This is why regulators should subject these participants to more stringent disclosure and reporting requirements.

Another common characteristic of derivatives is the amount of leverage on which these instruments are traded. Leverage allows one to make an investment with little or no upfront monetary payment.⁶⁰ In the OTC derivatives market, no exchange of funds may be required until maturity or performance.⁶¹ This enables an investor to hold exponentially larger positions than the amount committed.⁶² Although, in theory, this seems ideal because it reduces risk, in reality, leverage amplifies risk by spreading and multiplying it among multiple complex financial transactions, creating systemic hazards.⁶³

Because of these complex characteristics, derivatives can be extremely dangerous, not only to the OTC market, but to the economy as a whole. This potential danger stems largely from “users’ lack of knowledge and their under appreciation of the

58. See Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L. J. 701, 772 (1999) (discussing how speculation in the derivatives market is sometimes cheap and encourages investors to accept uncompensated risk). Stout introduces the idea that derivatives speculation increases systemic risk because of the number of financial firms exposing themselves to a great level of risk. *Id.*

59. See *Schapiro*, *supra* note 17, at 165 (stating the importance that some sort of regulatory framework exists to monitor those who could abuse the OTC market and increase the threat of systemic risk).

60. See RECHTSCHAFFEN, *supra* note 5, at 164 (introducing the concept of leverage and how it is beneficial to transactions in the derivatives market).

61. See *id.* (pointing out how an OTC derivative may not require any advancement until maturity, whereas an exchange-traded derivative requires a margin). See *infra* notes 165–68 and accompanying text for a description of margin.

62. See Topham, *supra* note 4, at 139–40 (discussing how financial leverage in the derivatives market can lead to an increased ability to take risks, therefore raising the chances of failure and systemic risk).

63. *Id.* at 140.

risks involved.”⁶⁴ This factor caused a number of losses stemming from derivatives use, including the economic crisis of 2008.⁶⁵

B. Types of OTC Contracts

1. Options

An option contract gives “the purchaser the right to buy (call option) or sell (put option) a specified quantity of a commodity or financial asset at a particular price (exercise price) on or before a certain future date.”⁶⁶ Option contracts function by having the purchaser pay the seller (writer) an option premium for the right to buy or sell.⁶⁷ The purchaser’s loss is limited to the price of the premium, enabling the purchaser to limit the downside of investment.⁶⁸ In contrast, the seller of an option receives the premium in return for risk exposure.⁶⁹

Like other derivatives, options may serve as hedging and speculating instruments, but, most importantly, options enable a buyer to eliminate all downside risk by paying a premium upfront.⁷⁰ Options do not expose the owner of an option to market risk because they create only a right to buy or sell, not an obligation.⁷¹ Options do expose the seller to some risk associated

64. See Edward A. Adams & David E. Runkle, *The Easy Case for Derivative Use: Advocating a Corporate Fiduciary Duty to Use Derivatives*, 41 WM. & MARY L. REV. 595, 629 (2000) (introducing the use of derivatives and regulatory structures applicable to derivatives in 2000).

65. See *id.* at 629–30 (stating how users’ lack of knowledge caused a number of financial losses in the 1990s, but these losses resulted in few lawsuits).

66. See GAO REPORT, *supra* note 9, at 27.

67. *Id.*

68. See RECHTSCHAFFEN, *supra* note 5, at 170–71 (discussing the operation and use of options).

69. See *id.*

70. See *id.* (noting that downside risk of an option is shifted completely to the seller).

71. See *id.* at 171 (explaining that the owner of an option is exposed to no market risk and, if they choose not to exercise an option, then they only lose the price of the premium).

with the underlying asset.⁷² The seller can hedge this risk, however, by investing in the underlying asset.⁷³

2. Forwards

A forward contract “obligate[s] the holder to buy or sell a specific underlying [asset] at a specified price, quantity, and date in the future.”⁷⁴ Forwards are customized contracts that allow market participants to hedge assets and liabilities by locking in a future purchase or sale price.⁷⁵ For example, if a U.S. importer plans to buy a product at a future date for a price quoted in a foreign currency, the U.S. importer can enter into a forward contract to fix the U.S. dollar cost of the product.⁷⁶ This allows the U.S. importer to hedge against currency fluctuations between the purchase and delivery dates.⁷⁷ Alternatively, market participants use forwards to speculate on market movements and profit from decreases or increases in future prices or rates.⁷⁸

3. Swaps

A swap is a complex instrument traded on the OTC market.⁷⁹ In a swap agreement, “two parties agree to exchange ‘cash flows’ on a ‘notional amount’ over a period of time in the future.”⁸⁰ This notional amount is a reference upon which the payment stream is

72. *See id.* (looking to how sellers of an option contract can limit their exposure to market risk).

73. *See id.*

74. *See* GAO REPORT, *supra* note 9, at 26 (defining a forward and describing the instrument’s use in the market).

75. *See id.* at 26 (providing an example of how a hedging participant could benefit from using a customized forward contract).

76. *See id.* at 5 (providing an example of how a party would utilize a forward contract).

77. *See id.*

78. *See id.* at 27 (discussing how a speculator attempts to profit in the forwards market).

79. *See* RECHTSCHAFFEN, *supra* note 5, at 172.

80. *See id.* (looking at swap agreements and discussing the characteristics of such contracts).

derived.⁸¹ A commonly transacted swap is the interest rate swap, which allows counterparties to exchange a fixed rate for a floating rate.⁸² For example, Party A invests in a bond with a par value of \$1000 and a fixed interest rate of 5% compounded annually.⁸³ Party B, however, owns a bond that pays a floating interest rate tied to the London Interbank Offered Rate (LIBOR).⁸⁴ Party B may prefer a more steady interest payment to hedge against the risk of a decreasing interest rate.⁸⁵ Party A, however, may want to trade his steady interest payment for a potentially larger interest payment.⁸⁶ If the two enter into an interest rate swap, then Party A is guaranteed his annual interest payment of \$50 plus any additional profit over \$50 on the two bonds.⁸⁷ Party B, on the other hand, is always guaranteed \$50.⁸⁸ Party B pays any amount over \$50 to Party A, while Party A, in turn, compensates Party B for any loss under \$50.⁸⁹

Because swaps are traded on the OTC market, parties can negotiate a contract that specifically reflects their needs, whether

81. See *id.* at 175 (describing the elements of a swap transaction prior to an overview of the types of swap transactions most frequently used in the market). Common transactions include interest rate swaps, currency swaps, and credit-default swaps. *Id.*

82. See *id.* at 175–77 (setting out how a “plain vanilla” interest rate swap works and provides benefits to the counterparties); see also Gogel, *supra* note 5, at 8–9 (providing a hypothetical example of how an interest rate swap works). These described transactions are constructed similarly to other swap contracts. *Id.*

83. See Gogel, *supra* note 5, at 8–9 (depicting this example).

84. See *id.* (Party B has a floating interest rate payment and wants to guarantee a specific payment so he transacts with Party A, who wishes to increase his guaranteed payment). For a description of LIBOR, see British Banking Ass’n, *Understanding BBA LIBOR*, (Jan. 8, 2011), <http://www.bba.org.uk/media/article/understanding-bba-libor> (last visited Sept. 27, 2012) (on file with the Washington and Lee Law Review). LIBOR is the London Interbank Offered Rate, which reflects the rate at which banks, such as the U.S. Federal Reserve and the European Central Bank, borrow money from one another daily. *Id.*

85. See Gogel, *supra* note 5, at 8–9.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

to hedge exposed credit risk from an owned asset or to profit by speculating on pricing inefficiencies in the market.⁹⁰

Swaps enable extreme flexibility to meet the contracting parties' needs, but, concurrently, expose these parties to high credit risk.⁹¹ Credit risk is the risk that a counterparty to the transaction will default on the contract.⁹² Ideally, credit risk is reflected in the contractual terms, but, due to information asymmetry, this is not always achievable.⁹³ AIG's issuance of multiple credit default swaps and inability to meet financial obligations when they became due provides a picture of how asymmetrical information can have damaging effects.⁹⁴ After the 2008 financial crisis, regulators set out to address these risks and pricing inefficiencies within the OTC swap market.⁹⁵ The next portion of this Note examines commercial end-users' role in the swap market and how proposed legislation may affect their participation.

III. End-User Participation in the OTC Market

End-users are a category of market participants that utilize the OTC market to hedge exposed market risk and minimize volatility of their overall earnings.⁹⁶ This category mainly

90. See Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 BUS. LAW. 1127, 1132 (2002) (explaining that OTC derivatives are used for both speculation and hedging, but they are more commonly used for hedging purposes).

91. See RECHTSCHAFFEN, *supra* note 5, at 172.

92. See Adams & Runkle, *supra* note 64, at 663 (providing a description of credit risk and how to manage it).

93. See Gogel, *supra* note 5, at 5 (discussing how lack of transparency in the market and nondisclosure between counterparties leaves regulators and participants unaware of potential risks building up in the financial market). This is a problem that Title VII of the Dodd–Frank Act aims to address. See Schapiro, *supra* note 17, at 165.

94. See *supra* notes 44–50 and accompanying text for a brief overview of the AIG bailout.

95. See Schapiro, *supra* note 17, at 164 (discussing the goals of Dodd–Frank with respect to regulating the OTC derivative market).

96. See PRACTICAL DERIVATIVES: A TRANSACTION APPROACH 10 (Jonathan Denton ed., 2006) (“Derivatives are typically used by corporate end users to reduce or extinguish their exposure to discrete risks and thus reduce the volatility of their earnings.”); Adams & Runkle, *supra* note 64, at 674 (“When

includes nonfinancial corporations, but asset managers and other financial institutions also qualify.⁹⁷ These users, and their investors, benefit greatly from using the OTC market to hedge risk.

For example, Shell Co. takes positions in the U.S. energy derivatives market to respond to internal forecasts of supply and demand, enabling Shell to be ahead of foreseeable price movements.⁹⁸ It also participates in the swap market to offset credit risk and assist actual transactions.⁹⁹ Kraft Foods employs risk management strategies to handle risks associated with volatility in interest rates, commodity prices, and foreign currency rates that entail entering into forward, option, and swap contracts.¹⁰⁰

Although a positive duty to hedge exposed risks may not exist, at least one court found that the board of directors of a company owes its shareholders a duty of care to instruct managers adequately about the use of hedging with derivatives.¹⁰¹ Such a ruling demonstrates that hedging in the derivatives market is a common practice among corporations, and it is in a board's best interest to examine whether it is beneficial for a corporation to take this risk management route.¹⁰²

properly used to hedge against risk, derivatives are an essential corporate tool.”).

97. See *ISDA Survey: Interest Rate Swaps*, *supra* note 35 (providing a list of categories of survey respondents).

98. See Letter from Robert Reilley, Vice President – Regulatory Affairs, Shell Energy North Am. (US), L.P., to David A. Stawick, Sec’y of the Comm’n, CFTC (June 21, 2011) [hereinafter Shell Letter] (listing the ways in which Shell Co. utilizes the derivative market) (on file with the Washington and Lee Law Review).

99. See *id.*

100. See Kraft Foods Letter, *supra* note 30 (describing how Kraft Foods and its affiliate companies utilize the derivative market).

101. See *Brane v. Roth*, 590 N.E. 2d 587, 591–93 (Ind. Ct. App. 1992) (concluding that the board of directors failed “to attain knowledge of the basic fundamentals of hedging to be able to direct the hedging activities and supervise the manager properly”).

102. See PRACTICAL DERIVATIVES, *supra* note 96, at 13 (discussing the court’s finding in *Brane v. Roth* and a corporation’s duty to hedge or, at a minimum, look to the mechanics of such a trade to determine if it is within the best interests of the corporation).

Companies, as mentioned previously, use the derivative market to manage risk and optimize value.¹⁰³

The OTC market enables end-users to tailor their derivative contracts to their needs.¹⁰⁴ High negotiation costs of OTC derivatives contracts makes trading on the market costly.¹⁰⁵ But this is the price end-users pay for a uniquely tailored contract. Prior to Dodd–Frank, participants in the market enjoyed the added benefit of no margin requirements.¹⁰⁶

According to a 2010 International Swaps and Derivatives Association (ISDA) survey, end-users stated that they use the OTC derivatives market primarily for interest rate swaps, currency swaps, credit default swaps, equity swaps, and energy swaps.¹⁰⁷ The results show that 80% use the OTC market for interest rate swaps, 59% for currency swaps, 27% for credit default swaps, 25% for equity swaps, and 32% for energy/commodity swaps.¹⁰⁸ The ISDA classified end-users as companies utilizing the market to manage exposed risk.¹⁰⁹ The group included nonfinancial corporations, asset managers, and other financial institutions.¹¹⁰ These instruments are so widely

103. See Kraft Foods Letter, *supra* note 30; see also Shell Letter, *supra* note 98 (discussing for what purposes Shell uses the derivative market and how the proposed end-user definition will affect Shell's ability to utilize the market via its subsidiary companies).

104. See Thomas C. Singher, Note, *Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?*, 18 *FORDHAM INT'L L.J.* 1397, 1406–08 (1995) (addressing the uses of the derivatives market to commercial users). One of the uses discussed is speculation, which, although not common for end-users, supports an argument to regulate these participants in some fashion. *Id.* at 1410–11.

105. See Gogel, *supra* note 5, at 9 (stating that swap contracts tend to have high transaction costs due to the extensive negotiations over delivering a party's specific needs).

106. See *infra* notes 122–28 and accompanying text for a description on Dodd–Frank's margin requirements.

107. See *ISDA Survey: Interest Rate Swaps*, *supra* note 35, at 2 (listing results from a survey of 295 respondents from North America and Europe who use the OTC derivatives market).

108. See *id.*

109. See *id.* The ISDA study includes more than just nonfinancial entities utilizing the OTC market for hedging exposed risks. *Id.* This Note proposes that the regulatory definition of end-user should include those surveyed as end-users by the ISDA.

110. See *id.*

used because companies across all industries utilize interest rate swaps and currency swaps.¹¹¹ Specific industries utilize commodity, equity, and credit derivatives.¹¹² For example, financial industries primarily use equity and credit derivatives, while companies focusing on utilities and basic materials utilize commodity derivatives.¹¹³

Because end-users typically use the OTC market specifically for hedging exposed market risk, Congress excluded these users from regulation under Title VII of Dodd–Frank.¹¹⁴ If mandatory clearing pertained to end-users, they would be required to post margin and use clearinghouses for all of their trades.¹¹⁵ This would increase the cost of using the OTC market and drive many end-users away from the market. As a result, corporate end-users would hedge their risks in nonbeneficial ways, such as through insurance contracts that increase transaction costs, which the corporation passes on to the consumers and investors.¹¹⁶

Although increased costs will drive end-users from the market, imposing minimal regulation for end-users is not the proper solution. It is possible that end-users are attracted to the market not only because of low transaction costs, but also because of the lack of regulation. Although most end-users are utilizing the market for hedging purposes, misusing these instruments is easy due to their complexity and large potential gains.¹¹⁷ For

111. See ISDA NEWS RELEASE, *supra* note 26, at 2 (breaking down results of a 2009 survey of end-user participation in the OTC derivative market by industry and country).

112. See *id.* at 4 (displaying a chart of the survey results broken down by industry sector and usage of each type of swap contract).

113. See *id.*

114. See Ariail, *supra* note 12, at 189 (explaining that Congress's rationale for excluding end-users from regulation stemmed from concerns for consumers who would suffer through increased costs due to corporations' inability to hedge risk and reduce overall losses).

115. See Dodd–Frank § 723, 7 U.S.C. § 2(h); *infra* Part IV.B (discussing Title VII of Dodd–Frank).

116. See Letter from Sen. Christopher Dodd & Sen. Blanche Lincoln to Rep. Barney Frank & Rep. Colin Peterson (June 30, 2010) (stating Congress's intention in exempting end-users from the market) (on file with the Washington and Lee Law Review).

117. See Guinn & Harvey, *supra* note 90, at 1128, 1130 (commenting on the possibility of abuse in the market due to some participant's lack of knowledge of the complex OTC derivatives).

example, one claiming the end-user exception could determine a way to abuse the exception by disguising speculation as hedging and increasing the threat of systemic risk.¹¹⁸ Does exemption from Dodd–Frank mandatory clearing provide end-users the best of both worlds—virtually no regulation and low transaction costs? This Note will analyze whether it is possible to broaden the class of end-users and keep the derivatives market attractive to end-users by maintaining low transaction costs.

IV. Regulation of the OTC Market

A. Past Regulation

Before introducing the current regulation of the OTC market, it is important to discuss briefly the evolution of regulation in the derivatives market, specifically of OTC derivatives. The regulatory framework of the derivatives market is a combination of the CFTC, the SEC, and a number of self-regulatory institutions.¹¹⁹ Although traders utilized OTC derivatives for a long period of time, the market rose to popularity in the 1980s.¹²⁰ Due to regulators' unfamiliarity with these new, complex instruments, OTC derivatives remained largely unregulated for some time.¹²¹ Originally, regulators focused on preventing manipulation and fraud in the derivatives market.¹²² Because OTC derivatives are less susceptible to manipulation, regulators did not see these instruments as a threat deserving of regulation.¹²³ Unfortunately,

118. See *infra* Part VI.

119. See Adam J. Krippel, Note, *Regulatory Overhaul of the OTC Derivatives Market: The Costs, Risks and Politics*, 6 *ENTREPREN. BUS. L. J.* 269, 278 (2011) (providing an overview of regulation in the derivatives market).

120. See Gary Gensler Testimony, *supra* note 7 (addressing why the OTC market was unregulated prior to 2008).

121. See Krippel, *supra* note 119, at 278.

122. See Gogel, *supra* note 5, at 18–23 (discussing the history of derivative regulation from the passage of the CEA in 1936 to the creation of the CFTC in 1974). Congress attempted to address issues of fraud and manipulation of the unregulated market. *Id.* Ultimately, this led to exempting the OTC derivatives from regulations in the 1992 amendments to the CEA, which attracted many critics. *Id.* at 23.

123. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-00-00, COMMODITY

the 1992 amendments to the 1936 Commodity Exchange Act (CEA), which governs regulation of the derivatives market, did not completely resolve this issue.¹²⁴ The 1992 amendments gave the CFTC power to exempt OTC derivatives from regulation.¹²⁵ Regulators justified nonregulation with the fact that participants were self-interested and sufficiently sophisticated to self-regulate.¹²⁶

Because government regulators failed to address issues beyond manipulation and fraud, private regulators began appearing in the 1990s to increase market transparency and disclosure.¹²⁷ In 1994, the Derivatives Policy Group introduced a voluntary oversight framework that would help address the public policy issues of the OTC derivatives market.¹²⁸ Its goal was to have more OTC market participants report their use and risk exposure in the market.¹²⁹

The Financial Accounting Standards Board (FASB) and the ISDA have made progress in making the derivatives market more transparent and efficient.¹³⁰ The ISDA uses a form document, known as the ISDA Master Agreement, which parties sign prior to entering into any derivatives contract.¹³¹ The ISDA Master

EXCHANGE ACT – ISSUES RELATED TO THE REGULATION OF ELECTRONIC TRADING SYSTEMS 10 (2009) (discussing how the OTC derivatives market remained unregulated because the instruments presented limited market integrity concerns).

124. *See id.* Because the OTC derivative market was not as susceptible to fraud and manipulation, regulators were not concerned with subjecting them to regulation. *See id.* at 28.

125. *See id.*

126. *See* Gary Gensler Testimony, *supra* note 7.

127. *See* Singher, *supra* note 104, at 1431–34 (looking at all the different private actors who have taken steps to help promote efficiency and transparency in the OTC market).

128. *See generally* Derivatives Policy Group, *Framework for Voluntary Oversight*, <http://riskinstitute.ch/137790.htm> (last visited Sept. 27, 2012) (presenting an approach to enhance reporting and evaluation of risk in the OTC market) (on file with the Washington and Lee Law Review).

129. *See id.*

130. *See* Singher, *supra* note 104, at 1431–33 (discussing additional regulatory influences on the OTC derivatives market beyond statutory guidelines).

131. *See* Frank Partnoy, *ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?* 5–6 (San Diego Law Sch. Pub. Law & Legal Theory Working Paper No. 39, 2002) (introducing the ISDA and how it

Agreement specifies a number of things, including the obligations of the parties and the relevant events of default.¹³² If the standard form contract is unfavorable to one party, it can either negotiate this term in each of its contracts or accept the standard terms.¹³³ This practice promotes efficiency for members, and the documents further provide guidance in judicial decisions.¹³⁴

While private groups were encouraging self-regulation, some advocated for statutory regulation of the OTC market.¹³⁵ Though OTC derivatives did not pose a risk of manipulation in the late 1990s when the argument to regulate was introduced, some saw that the rapidly changing structure of this market and the recent large losses in the market required a regulatory response.¹³⁶ The Government Financial Officers Association presented the idea that derivatives posed a bigger threat than the benefit they offered.¹³⁷ Most notably, Brooksley Born, Commissioner of the CFTC from 1996–1999, testified before Congress on the perils that the derivatives market posed and how regulators should address these dangers.¹³⁸

privately regulates the OTC derivatives market).

132. See *id.* at 6 (outlining what the ISDA Master Agreement and Schedule specifies to reduce counterparty risk).

133. See Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211, 254 (2001) (presenting the downside to using the ISDA standard form contract).

134. See *id.* at 6–10 (presenting the idea that the ISDA’s private law, addressing issues unanticipated by judges and regulators, will continue to be used in judicial opinions).

135. See CFTC Concept Release, *Over-the-Counter Derivatives* (May 7, 1998), <http://www.cftc.gov/opa/press98/opamntn.htm> (last visited Sept. 27, 2012) (proposing a regulatory scheme for the OTC market) (on file with the Washington and Lee Law Review). This proposal was opposed by financial regulators, Greenspan and Rubin, who essentially stated that such regulation would cause a financial crisis. See Krippel, *supra* note 119, at 279 (discussing the negative reaction to Brooksley Born’s regulatory proposal).

136. See *Financial Derivatives Supervisory Improvement Act of 1998 and the Regulation of the OTC Derivatives Market: Hearing on H.R. 4062 Before the H. Comm. on Banking and Fin. Serv.*, 105th Cong. 177 (1998) (statement of Brooksley Born, Chairman, CFTC) [hereinafter *Hearing on H.R. 4062*].

137. See GOV’T FIN. OFFICERS ASSOC., 1994 SURVEY OF DERIVATIVE PRODUCTS IN THE DEBT MARKET 124 (1994).

138. See *Hearing on H.R. 4062*, *supra* note 136, at 313.

Failure to keep pace with the changing market would stifle the capacity of U.S. firms to meet global competitive challenges, would create a cloud of legal uncertainty over the applicability of outdated rules to new products and innovative transactions, and would erode the regulatory system's ability to protect customers and to preserve the financial integrity of that market.¹³⁹

Her proposal considered the clearing of derivatives, OTC derivatives market users' registration and reporting to the CFTC, capital requirements, requirement of risk management controls for derivatives dealers, and restrictions on dealers' sale practices.¹⁴⁰ This idea met strong opposition from other regulators who believed that regulation would hinder the efficiency of the OTC derivative market.¹⁴¹

Born's fear became real in 2008. But, in 1999, proponents for deregulation won the day in Congress. Alan Greenspan, then Federal Reserve Chairman, claimed that the proposed regulatory scheme would "distort the efficiency of [the U.S.] market system and as a consequence [impede] growth and improvements in standards of living."¹⁴²

With Greenspan's encouragement, Congress rejected regulation of OTC derivatives and passed the Commodity Futures Modernization Act of 2000 (CFMA).¹⁴³ With this Act, Congress ensured that the CFTC would not regulate OTC derivatives by expressly exempting them from the CFMA legislation.¹⁴⁴ Essentially, the CFMA's goal was to promote innovation, enhance legal certainty, and provide greater stability in the derivatives

139. *Id.*

140. See CFTC Concept Release, *supra* note 135.

141. See *Hearing on the Regulation of OTC Derivatives Before the H. Comm. on Banking and Fin. Serv.*, 105th Cong. 303 (1998) (testimony of Alan Greenspan, Chairman, Federal Reserve).

142. See *id.*

143. See Reade Everett, *Deriving a Solution for Derivative Reform: Proposals to Reconstruct the Over-the-Counter Derivatives Market*, 28 REV. BANKING & FIN. L. 479, 483 (2009).

144. See 7 U.S.C. § 2(g)(1) (2010) (exempting agreements entered into by eligible contract participants that are "subject to individual negotiation by parties").

market.¹⁴⁵ As a result, private parties could negotiate OTC derivatives contracts without being subject to any regulation.¹⁴⁶

Some feel that perhaps Born and Greenspan were both wrong in their regulatory endeavors. Lynn Stout argues that the deregulation of derivatives led to disaster by making swap contracts legally enforceable through the CFMA, which was unprecedented.¹⁴⁷ Stout proposes a form of self-regulation that would hold dealers personally responsible for risky, speculative decisions, by making speculative OTC contracts not legally enforceable.¹⁴⁸ This is how the law viewed derivatives contracts prior to 2000 and Stout believes this is the best way to regulate now.¹⁴⁹ In essence, Lynn Stout's answer is to treat an OTC swap contract as a gambling contract, just as it was once done centuries ago.¹⁵⁰ This Note will address this idea further in Part V.B.1.

B. Dodd–Frank Regulation

For years, regulators recognized that the OTC market lacked oversight.¹⁵¹ In 1994, the Comptroller General of the United States called for uniform regulation of the OTC market.¹⁵² In

145. See Gogel, *supra* note 5, at 24 (discussing the intention and effect of the CFMA).

146. See *id.* (stating the result of deregulation in the OTC market). Gogel introduces the idea that deregulation of OTC transactions directly contrasts with the intention of the CFMA to promote transparency, decrease systemic risk, and provide stability in the market. *Id.*

147. See Stout, *Deregulating Derivatives*, *supra* note 6, at 30 (“[The] rule of unenforceability encouraged speculators to rely on private ordering and to develop and police their own private markets.”).

148. See *id.*

149. See *id.*; Lynn A. Stout, *Regulate OTC Derivatives by Deregulating Them*, BANKING & FINANCE 34 (Fall 2009) [hereinafter *Regulate OTC Derivatives*] (proposing an idea to treat speculative contracts as gambling contracts to give dealers more accountability for their actions).

150. See Stout, *Regulate OTC Derivatives*, *supra* note 149, at 34–35; see *infra* notes 196–99.

151. See Gogel, *supra* note 5, at 31–32 (“On October 8, 2008, Christopher Cox, then Chairman of the SEC, characterized the lack of oversight of the OTC derivatives market as a ‘regulatory black hole.’”).

152. See GAO REPORT, *supra* note 9, at 126–27 (“Given the weaknesses and gaps that impede regulatory preparedness for dealing with a crisis associated

1998, Brooksley Born reaffirmed the importance of regulating this vast market.¹⁵³ Unfortunately, the government did not act to regulate the OTC market until it was too late.

Title VII of Dodd–Frank addresses the regulation of the OTC derivatives market, particularly swaps.¹⁵⁴ The legislation’s overall goal is to lower risk to the American public and to promote transparency in the OTC market.¹⁵⁵ The major rules that the CFTC and SEC are currently promulgating are set out below.

Dodd–Frank gives the CFTC and the SEC jurisdiction over swap regulation.¹⁵⁶ The SEC has jurisdiction over security-based swaps and the CFTC has exclusive jurisdiction over all nonsecurities based swaps, including interest rate swaps and currency swaps.¹⁵⁷ Dodd–Frank requires the CFTC to coordinate with the SEC and other agencies prior to issuing rules or orders in connection with swap regulation.¹⁵⁸ Dodd–Frank also mandates that the CFTC and SEC engage in joint rulemaking to define terms, including “swap,” “security-based swap,” “swap dealer,” and “major swap participant.”¹⁵⁹

One of the major changes that Dodd–Frank imposes on the OTC market is the mandatory clearing of swaps.¹⁶⁰ This regulatory approach requires all qualifying swaps to be traded through a heavily regulated third-party, called a derivatives clearing organization (DCO).¹⁶¹ This aims to reduce systemic risk

with derivatives, we recommend that Congress require federal regulation of the safety and soundness of all major U.S. OTC derivatives dealers.”).

153. See *Hearing on H.R. 4062*, *supra* note 136, at 177–78.

154. See *id.* at 40 (introducing different sections of the Financial Reform Act and what each section aims to regulate).

155. See *OTC Derivatives Markets Act of 2009 Discussion Draft: Hearing Before H. Comm. on Fin. Serv.*, 111th Cong. 2, 5 (2009) (statement of Gary Gensler, Chairman, CFTC) [hereinafter *OTC Derivatives Markets Act of 2009 Hearing*].

156. Dodd–Frank Act § 722(a).

157. *Id.*

158. *Id.* § 712.

159. *Id.* § 712(d)(1). The definitions of these terms are finalized. See 77 Fed. Reg. 30596 (May 23, 2012) (to be codified at 17 C.F.R. pt. 1).

160. See Gogel, *supra* note 5, at 48–50 (looking at the costs and benefits of derivatives clearing).

161. See Gubler, *supra* note 5, at 86–87 (discussing approaches to managing counterparty risk and the effects of these approaches, specifically the central clearing requirement).

by putting OTC transactions on the books of regulated clearinghouses and not large financial institutions.¹⁶² Central clearing also aims to reduce counterparty risk, leading to more accurate pricing.¹⁶³

Central clearing will require participants, with some exceptions, to set initial margin requirements.¹⁶⁴ Margin is a cash balance in a trader's account with the clearinghouse.¹⁶⁵ If the balance in this account falls below a certain amount, the trader must post additional collateral to maintain a balance established by the clearinghouse.¹⁶⁶ A portion of the contract settlement amount determines the margin requirement.¹⁶⁷ This guarantees that parties back up investments with an adequate amount of capital.¹⁶⁸ Due to uncertainty in derivatives pricing and fluctuation of an underlying asset's price, a trader may be required to post a considerable amount of collateral.¹⁶⁹ While providing upfront collateral is important, it is an incredibly thorny topic because of the difficulty in pricing derivatives and determining an accurate settlement price on which to base a margin calculation.¹⁷⁰

162. See *OTC Derivatives Markets Act of 2009 Hearing*, *supra* note 155, at 4 (addressing how the clearing organizations will help to lower risk to the American public).

163. See Gubler, *supra* note 5, at 92 (explaining how the DCO in the OTC market will overcome counterparty risk by providing an example). Although the DCO is designed to eliminate counterparty risk and increase transparency, the use of a central party clearing may increase costs in obtaining information that in the current bilateral framework is not public. *Id.* at 94.

164. See Ariail, *supra* note 12, at 185 (providing an overview of central party clearing in the OTC market).

165. See *id.* at 185 n.74 (explaining briefly the basics of margin).

166. See *id.*

167. See Gogel, *supra* note 5, at 50 (explaining the purpose of margin requirements).

168. See *id.*

169. See, e.g., Letter from Darrel E. Issa, Chairman, Comm. on Oversight and Gov't Reform, to Ben Bernanke, Chairman, Fed. Reserve (July 22, 2011), <http://thinkprogress.org/wp-content/uploads/2011/08/IssaLetter.pdf> (stating that the Office of the Comptroller of the Currency (OCC) estimates that the initial margin posted in one year will total \$2.56 trillion).

170. See Gubler, *supra* note 5, at 105–06 (examining the problems collateral requirements may pose for OTC market users).

These regulations apply only to swap dealers and major participants.¹⁷¹ Congress's goal in enacting this section of Dodd–Frank was to guarantee that margin and collateral requirements would not hinder end-users who utilize the market for pure hedging purposes.¹⁷² Congress wanted these participants to use funds for business investment and job creation, rather than margin requirements.¹⁷³ Determining which participants utilize the market for these reasons and, consequently, whom to exempt from regulation is a problem.¹⁷⁴ The next portion of this Note examines the end-user exception, which carries out this goal of Congress.

V. End-User Exception to the Mandatory Clearing of Swaps

Dodd–Frank gives the CFTC authority to adopt rules exempting certain swaps from the clearing mandate.¹⁷⁵ Aiming to protect the American public by regulating systemic risk in the OTC market, the CFTC promulgated a rule defining the end-user.¹⁷⁶

171. See Dodd–Frank § 723(a)(3); Gogel, *supra* note 5, at 45–46 (discussing the Dodd–Frank regulations of the OTC swap market).

172. See 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (statement of Sen. Blanche Lincoln) (stating that the legislation may not require some OTC market users to post margin, it will require them to satisfy public reporting requirements as set out in Dodd–Frank).

173. See John Carney, *Will the CFTC Kill the End User Exemption?*, CNBC NETNET (Oct. 4, 2010), http://www.cnbc.com/id/39506763/Will_The_CFTC_Kill_The_End_User_Exemption (last visited Sept. 27, 2012) (discussing whether the CFTC has the authority to subject end-users to margin requirements) (on file with the Washington and Lee Law Review).

174. See Ariail, *supra* note 12, at 194 (“[T]he most problematic part of policing the end-user exemption . . . is distinguishing when an end-user is ‘hedging or mitigating commercial risk’ rather than taking a speculative position in derivatives markets.”).

175. See End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (proposed Dec. 23, 2010) (to be codified at 17 C.F.R. pt. 39) (“[T]he Dodd–Frank Act provides the Commission with the authority to adopt rules governing the end-user clearing exception and to prescribe rules, issue interpretations, or request information from persons claiming the end-user clearing exception necessary to prevent abuse of the exception.”).

176. See *id.*

The end-user exception is limited to nonfinancial entities and does not completely eliminate their transactions from regulation.¹⁷⁷ A nonfinancial entity includes users who do not hold investment positions for profit in the OTC market.¹⁷⁸ The rule disqualifies any swap used for any speculative or trading purposes, or if used to hedge another swap.¹⁷⁹ The rule requires that a nonfinancial entity claiming exempt status must disclose to the Commission its intention of claiming the exemption and how it generally plans to meet financial obligations.¹⁸⁰ Some commenting on the proposed rule feel this regulation is burdensome and will not effectively increase price transparency in the swap market.¹⁸¹ Companies, like Shell, argue that overly aggressive regulation could undermine efficiencies appreciated in the OTC market and could distort pricing without promoting transparency.¹⁸²

A. Rule Design: Narrow Versus Broad

By passing Title VII of Dodd–Frank, Congress wanted to increase transparency in the OTC market and decrease the threat of systemic risk.¹⁸³ Regulators aim to promote public transparency in addition to transparency to regulators.¹⁸⁴ The CFTC hopes that public transparency will improve the function of the OTC market, much as it has existing securities and futures

177. Commodity Exchange Act, 7 U.S.C. § 2(h)(7)(A)(i) (as amended by Dodd–Frank).

178. See 7 U.S.C. § 2(h)(7)(C)(i) (providing a list of what users qualify as a financial entity).

179. See 75 Fed. Reg. 80747 (explaining that the Commission finds all swaps held for appreciation in value to be speculative).

180. See *id.* (proposing that end-users notify the Commission each time the clearing exception is elected by providing specified information as set out in the swap data recordkeeping and reporting rules).

181. See Shell Letter, *supra* note 98, at 5 (explaining how compliance with data reporting for end-users will not provide an accurate portrayal of one's exposure in the market).

182. See *id.* at 2 (stating that real time reporting requirements for swaps between an affiliate and a corporation do not promote the aims of Dodd–Frank).

183. See Schapiro, *supra* note 17, at 166.

184. See Gary Gensler Testimony, *supra* note 7 (discussing the Dodd–Frank legislation and what it aims to promote in the OTC market).

markets.¹⁸⁵ Although Title VII of Dodd–Frank regulates the vast and dangerous OTC market, Congress did not want the SEC and CFTC to regulate certain users.

The end-user exception rule allows for commercial end-users to utilize the OTC derivatives market without the added cost of margin requirements and central clearing.¹⁸⁶ Section 2(h)(7) of the Commodity Exchange Act (CEA), as amended by Dodd–Frank, provides:

[T]hat a swap otherwise subject to mandatory clearing is subject to an elective exception from clearing if one party to the swap is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.¹⁸⁷

Commentators to the end-user exception raised questions pertaining to a participant who does not qualify as a nonfinancial entity, but (a) cannot afford to meet hedging requirements, such as small banks, which are not systemically significant, and (b) uses the OTC market to hedge or mitigate risk, such as corporations' affiliate companies.¹⁸⁸ These commentators were concerned that they would not qualify for the end-user exemption and therefore must comply with mandatory clearing requirements or leave the market.¹⁸⁹

In response to these concerns, Congress introduced a bill that would require the CFTC to exempt inter-affiliate swaps from mandatory clearing.¹⁹⁰ Inter-affiliate swaps are swaps that have

185. *See id.*

186. *See* 75 Fed. Reg. 80747.

187. Commodity Exchange Act, 7 U.S.C. § 2(h)(7) (as amended by Dodd–Frank).

188. *See* Letter from Nat'l Rural Util. Cooperative Fin. Corp., to David A. Stawick, Secretary of the Comm'n, CFTC (Jan. 12, 2011) [hereinafter NRUCFC Letter] (addressing the issue of small financial entities utilizing the OTC market for reasons and in ways far different from large financial lenders, which would justify the small lenders inclusion in the end-user exception) (on file with the Washington and Lee Law Review); *See* Kraft Foods Letter, *supra* note 30, at 9 (arguing that affiliate corporations, formed to act as a centralized hedging center to hedge exposed risk for an entire corporate group, should be included in the CFTC's end-user definition).

189. *See id.*

190. *See* To Exempt Inter-affiliate Swaps from Certain Regulatory

a corporation on one side of the transaction and, on the other side, a party that is controlled or under common control of the corporation that is a counterparty to the transaction.¹⁹¹ This bill has yet to be enacted and may force the CFTC to broaden its narrowly proposed definition.

The problem this poses is that the current design of the rule does not support a broad end-user definition. The CFTC defines end-user to include more participants, such as small banks, but does not subject the users to more regulatory requirements. Congress's intention is to exempt end-users from the mandatory clearing of swaps to maintain low transaction costs, but imposing minimal regulatory requirements only hampers regulators' efforts in creating a more transparent market.¹⁹² This Note argues that more disclosure is necessary for the end-users exempted from the mandatory clearing of swaps.

B. Alternative Rule Design

Based on the difficulty of pricing derivatives, the complexity of calculating margin requirements, and the uncertainty of financial innovation, can regulators effectively increase market transparency and decrease systemic risk in the OTC derivative market? This Note argues that more disclosure will help increase transparency, but that regulators will have difficulty in maintaining transparency with the ever changing land scape of financial innovation.

Requirements Put in Place by the Dodd–Frank Wall Street Reform and Consumer Protection Act, H.R. 2779, 112th Cong. __ (2012) (introduced on Aug. 1, 2011 and currently extended for further consideration ending as of Mar. 8, 2012).

191. See James Hamilton, *House Ag Committee Approves Legislation Exempting Inter-Affiliate Swaps from Dodd–Frank Derivatives Requirements*, Jim Hamilton's World of Securities Regulation (Sept. 27, 2012, 2:44 PM), <http://jimhamiltonblog.blogspot.com/2012/01/house-ag-committee-exempts-inter.html> (last visited Sept. 27, 2012) (on file with the Washington and Lee Law Review).

192. See *infra* Part V.B.1.

1. *Alternative Approaches to OTC Derivatives Regulation*

The CFMA's deregulation of the OTC derivatives market proved ineffective, as it is alleged to be a cause of the 2008 financial crisis.¹⁹³ By flying under the radar of regulators, the OTC market grew to an extraordinary size within the years leading up to the financial crisis.¹⁹⁴ Title VII of Dodd–Frank aims to protect the American public from the systemic risk that the OTC market poses by increasing transparency and disclosure in the market.¹⁹⁵ Part IV.B. and Part V examine Title VII's efforts to achieve these goals. This Note now introduces alternative, perhaps better, approaches to derivatives regulation.

First, as mentioned in Part IV.A, Lynn Stout proposes that regulators should treat OTC derivatives contracts as gambling contracts.¹⁹⁶ Traditionally, speculative derivatives contracts were legally unenforceable wagers.¹⁹⁷ Stout argues that because derivatives are technically bets on future market conduct, it makes sense for regulators to treat these contracts as gambling contracts.¹⁹⁸ It encourages participants to be more careful in choosing counterparties and to take responsibility for their bets.¹⁹⁹

Second, voluntary reporting institutions, such as the ISDA and the Derivatives Policy Group mentioned in Part IV.B., allow

193. See Topham, *supra* note 4, at 147–49 (discussing how the CFMA's deregulation of derivatives resulted in participants not being aware of the underlying risks associated with these instruments).

194. See *id.* at 148 (stating the notional amount of the derivatives market was estimated at \$604 trillion in 2009, with major commercial banks holding positions that totaled \$204 billion).

195. See Schapiro, *supra* note 17, at 164 (listing the aims of the Dodd–Frank legislation).

196. See *supra* notes 147–50 and accompanying text (introducing Lynn Stout's theory on regulating derivatives as gambling contracts).

197. See Stout, *Regulate OTC Derivatives*, *supra* note 149, at 30 (discussing how derivatives were regulated prior to the passage of the CFMA in 2000).

198. See *id.* at 30–31 (stating that, for centuries, speculative derivative contracts were treated as legally non-enforceable contracts just as gambling contracts due to the level of risk in the bet).

199. See *id.* at 32 (presenting the idea that speculative participants in the derivatives market are encouraged to choose counterparties wisely and to create a private market on which speculative participants trade, therefore minimizing systemic risk).

for participants to trade under standardized contracts.²⁰⁰ This enables a more concrete report of activity in the OTC market.²⁰¹ These institutions have made progress in reducing counterparty risk, but unfortunately could not prevent the 2008 financial crisis.²⁰²

A third approach would regulate the conduct of users and not the specific instruments.²⁰³ This view looks to the major issues of the OTC market that regulators must address, namely counterparty risk and financial innovation.²⁰⁴ This approach seems similar to Dodd–Frank in that the legislation carves out an exception for end-users who utilize the market for hedging and requires speculators in the market to meet collateral requirements and mandatory clearing.²⁰⁵

The final regulatory method builds on the last approach. It proposes that regardless of the conduct of the participant, all participants should adhere to disclosure requirements greater than just checking a box, as the current proposed rule sets out for end-users.²⁰⁶ The CFTC must set more stringent disclosure requirements so regulators can monitor the market for abuse of the end-user exception.²⁰⁷ Regulators should require end-users to

200. See *supra* notes 128–34 and accompanying text for an introduction of these institutions and their policy goals.

201. See *id.*

202. See Symposium, *Regulatory Reform and the Future of the U.S. Financial System: An Examination of Dodd–Frank Regulation: Panel 1: Derivative Regulation*, 7 N.Y.U. J. L. & BUS. 439, 448–51 (2011) (discussing ISDA contracts and their use in the OTC market).

203. See Willa E. Gibson, *Are Swap Agreements Securities or Futures?: The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. CORP. L. 379, 414 (1999) (introducing the idea to regulate OTC derivatives by conduct, i.e. speculation and hedging, and not by the type of instrument).

204. See *id.* at 412–15 (regulating conduct helps address major concerns of the OTC market while “achiev[ing] a balance between market efficiency and market integrity”).

205. See *supra* Part V.A.

206. See 75 Fed. Reg. 80747; Letter from Michael Greenberger, Professor, Univ. of Md. Sch. of Law, to David A. Stawick, Sec., CFTC (Feb. 22, 2011) [hereinafter Greenberger Letter] (proposing to the CFTC that the end-user exception rule should enhance disclosure requirements to be more effective and align with the aims of Dodd–Frank).

207. See Greenberger Letter, *supra* note 206, at 3 (stating that a “check-the-box” approach is inadequate because it does not give regulators the proper

give more specific detail of how they will meet financial obligations, rather than just a general overview as the rule suggests.²⁰⁸ By adding this disclosure and other reporting requirements that provide a detailed outline of how end-users are hedging risk, regulators would be aware if end-users are adequately mitigating risk and not abusing the exception with speculation.²⁰⁹

VI. Amendment to the End-User Exception

The mandatory clearing of swaps aims to protect the American public from a financial crisis like that of 2008, but exempting end-users from other forms of regulation does not entirely meet the goals of Dodd–Frank. Exempting end-users from mandatory clearing is necessary for corporations to run their businesses effectively and efficiently by minimizing any potential devastating downside risk that could harm consumers.²¹⁰ Additionally, if regulators require end-users to post margin and collateral, then the additional cost incurred would most likely be transferred to the consumer.²¹¹ This Note proposes that the CFTC amend the end-user exception to apply to a broader number of participants and, in doing so, require more stringent disclosure similar to that of the ISDA Master Agreement.

information to monitor whether end-users are abusing the exception).

208. See 75 Fed. Reg. 80747. See also Greenberger Letter, *supra* note 206.

209. See Letter from Americans for Fin. Reform to Elizabeth M. Murphy, Sec., SEC (Feb. 4, 2011) [hereinafter Am. for Fin. Reform Letter] (presenting a proposal for enhanced disclosure and reporting for end-users claiming the exception to the mandatory clearing of swaps) (on file with the Washington and Lee Law Review); Greenberger Letter, *supra* note 206.

210. Christine Cuccia, *Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives*, 22 DEL. J. CORP. L. 197, 198 (1997) (discussing the ways in which corporations utilize the OTC market to hedge risk).

211. See Katharine Rose, *Annuity Issuers Eye Dodd–Frank Act*, NAT'L UNDERWRITER/ LIFE & HEALTH FIN. SERV., Vol. 114 Issue 16, 12 (Aug. 23, 2010) (addressing concerns of insurers, such as MetLife and Harvard Financial Services Group, that an increased price of using derivatives would result in high costs to customers using financial services).

A. Proposal for End-User Disclosure

Before this Note proposes how the CFTC should model end-users' disclosure requirements, it will briefly discuss why the other alternative approaches in Part V.B.1. do not sufficiently address the concerns posed by the OTC market. First, Lynn Stout's theory to view OTC speculative contracts as gambling contracts does not meet the aims of Dodd–Frank. This approach would encourage investors to take responsibility for their risky behavior by making them individually responsible for any losses incurred on the contract.²¹² Unfortunately, this may not decrease systemic risk and promote transparency because it keeps regulators uninformed about market activity. Also, regulators have a difficult task in dissecting the difference between speculative and legitimate hedging contracts.²¹³ Due to the market disruption that OTC derivatives allegedly caused in 2008, regulators cannot ignore the threat the market poses and must do more than just make derivatives legally unenforceable.

The second approach to have nongovernmental institutions, such as the ISDA and the Derivatives Policy Group, continue in their efforts of promoting efficiency and transparency in the OTC market could be successful. Dodd–Frank focuses on the United States' regulation of the OTC market, and not necessarily the international market, as do these other groups.²¹⁴ While these institutions have made extraordinary improvement in the OTC market, it was not sufficient to prevent the 2008 crisis.²¹⁵

The third and fourth approaches introduced in Part V.B.1 combine to make the best approach to regulating OTC derivatives, specifically end-users. This Note advocates maintaining an exemption of end-users from the mandatory clearing of swaps because they are not engaging in purely

212. See Stout, *Regulate OTC Derivatives*, *supra* note 149, at 31–32.

213. See Kreitner, *supra* note 55, at 1135–36 (introducing the idea that the increasing popularity of OTC derivatives caused much discussion on the difficulty in distinguishing investment from gambling).

214. See generally Derivatives Policy Group, *supra* note 128; ISDA, *ISDA Safe, Efficient Markets*, ISDA 2011 BROCHURE, available at http://www.isda.org/uploadfiles/_docs/ISDA_Brochure_2011.pdf (explaining the ISDA's purpose and who it aims to serve).

215. See *supra* note 5 and accompanying text (listing a number of suggested theories of how OTC derivatives contributed to the 2008 financial crisis).

speculative behavior. This mirrors the approach of regulating behavior in contrast to regulating a particular instrument.²¹⁶ This Note proposes that the CFTC should define end-user broadly to enable more bona-fide hedging participants to claim the exemption. A broader exception would allow more users to effectively hedge against exposed risks for low transaction costs.

The more broadly the CFTC defines an end-user, however, the greater the danger that the proposed regulation will not adequately protect against systemic risk and increase transparency.²¹⁷ This stems from the idea that the more participants who qualify as end-users, and are thus subject to minimal regulation, the less effective the legislation will be in promoting transparency.²¹⁸ More stringent disclosure requirements will help address this issue.²¹⁹ Some end-users wish that their trading positions remain private so others will not mimic their contracts and make their hedging strategies ineffective.²²⁰ This concern does not change the necessity of regulators' awareness of OTC market activity to assure that no participants are abusing the end-user exception.

As discussed in Part V.A, the end-user exception provides that those claiming the exemption must only disclose that they intend to use the exemption and how they generally plan to meet financial obligations.²²¹ Such a boilerplate disclosure statement will not adequately address Dodd–Frank's aims to increase transparency and decrease systemic risk in the OTC market. This Note argues that disclosure and reporting requirements should resemble the terms of the ISDA Master Agreement, which is

216. See *supra* notes 203–04 and accompanying text.

217. See Greenberger Letter, *supra* note 206 (explaining how not enhancing disclosure and reporting requirements will prevent regulators from adequately monitoring the market for abuse of the end-user exception).

218. See *id.*

219. See Am. for Fin. Reform Letter, *supra* note 209; *supra* notes 207–09 and accompanying text.

220. See Michael Sackheim & Elizabeth M. Schubert, *Dodd–Frank Act Has Its First Birthday, but Derivatives End Users Have Little Cause to Celebrate*, 2 HARV. BUS. L. REV. ONLINE 8 (July 21, 2011), available at http://www.blr.org/wp-content/uploads/2011/07/Schubert-Derivatives_End_User.pdf (discussing end-users' fear that public disclosure would make trading strategies ineffective).

221. See *supra* note 187 and accompanying text.

already utilized by many participants in the OTC market.²²² For over 20 years, the ISDA has tackled the issue of promoting transparency and pricing efficiency in the OTC market while adapting to the constant changes in financial innovation.²²³ The CFTC could look to how the private sector promoted financial stability in the market and build off that model.

The ISDA Master Agreement provides for increased documentation of parties' transactions and for close-out netting in the event of default.²²⁴ To promote economic certainty, the Master Agreement allows for the nondefaulting party to elect an early termination date and potentially receive money if the party incurs a loss while entering into a new derivatives contract.²²⁵ These provisions lower credit and legal risk for participants.²²⁶

The CFTC could follow the standard form contract, which promotes low transaction costs, and require parties to provide additional disclosure of obligations or contract terms where they differ from the standard form.²²⁷ While the Master Agreement provides for disclosure of types of collateral thresholds, exposure calculations, payment schedules, netting, and standard contract terms, the CFTC must ensure that parties provide concrete specifics of their ability to meet financial obligations.²²⁸ Parties need to have adequate information to reduce counterparty risk, while regulators need the same data to moderate systemic risk.

The regulation focuses on requirements and needs of the OTC derivatives market as it stands today. With the rapidly changing landscape of financial markets, especially the OTC derivatives market, regulatory schemes may quickly become

222. See Partnoy, *supra* note 131, at 6 (providing an overview of what the ISDA Master Agreement requires the parties to disclose).

223. See *ISDA Safe, Efficient Markets*, *supra* note 214 (describing the ISDA's aim to promote efficiency, accuracy, and stability in the OTC market).

224. See PRACTICAL DERIVATIVES, *supra* note 96, at 29 (discussing the concept of close-out netting, an important aspect of the ISDA Master Agreement).

225. See *id.*

226. See *id.* at 29–30.

227. See Partnoy, *supra* note 131, at 9 (stating that standard form derivatives documentation is cost reducing).

228. See PRACTICAL DERIVATIVES, *supra* note 96, at 27 (displaying the structure of the ISDA documentation at the relationship and transactional levels).

weak or ineffective.²²⁹ Because of the rapid growth of the OTC market and the complexity of financial innovation, regulators have difficulty in adequately addressing the concerns and risks this market poses.²³⁰ This Note argues that end-users should meet disclosure requirements as set out in the ISDA Master Agreement. It will allow regulators to guarantee that the market is more transparent to address the issues that they see fit.²³¹

VII. Conclusion

The regulation of OTC derivatives has long been a controversial topic, as seen in the debate between Brooksley Born and Alan Greenspan in the late 1990s.²³² In 2000, with the passage of the CFMA, regulators believed the best route was to deregulate the OTC market.²³³ Unfortunately, this led to a vast, complex, unregulated market that many claim played a role in the financial crisis of 2008.²³⁴ The financial crisis demonstrates to regulators that OTC derivatives carry a threat of systemic risk that needs to be controlled.

This led Congress to pass Title VII of Dodd–Frank, which aims to address the threat of systemic risk by promoting transparency in the market.²³⁵ The CFTC proposed legislation that requires the mandatory clearing of swaps, which entails margin requirements that are quite costly to the parties of the transaction.²³⁶ Pursuant to Congressional intent, the CFTC proposed an exemption for nonfinancial entities who utilize the

229. See Iman Anabtawi & Steven Schwartz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1361 (2011) (presenting the idea that it is difficult to regulate financial markets because they are rapidly changing and adapting to new innovations).

230. See, e.g., *id.*

231. See *supra* notes 207–09 and accompanying text (introducing the proposal of more stringent disclosure requirements to allow a broad end-user exception).

232. See *supra* notes 138–44 and accompanying text.

233. See *supra* notes 143–44 and accompanying text.

234. See *supra* notes 4–5 and accompanying text (introducing theories as to how the OTC market played a role in the 2008 financial crisis).

235. See *OTC Derivatives Markets Act of 2009 Hearing*, *supra* note 155, at 5.

236. See *supra* Part IV.B.

market to hedge underlying risk.²³⁷ This exemption is meant to maintain low transaction costs for these participants. While this is a legitimate concern for end-users, the CFTC should impose more stringent disclosure requirements than just checking the exemption box and generally disclosing how the party will meet financial obligations.²³⁸

This proposal is to aid regulators in monitoring the end-users to determine who is validly claiming the exemption and who is abusing the exception by speculating.²³⁹ While this may increase costs to end-users to some extent, it will decrease the threat of systemic risk to the American public and promote transparency in the OTC market, the aims of Dodd–Frank.

Foreseeing and preventing a financial crisis of the magnitude of the one in 2008 is an extremely difficult task. Financial innovation and the complexity of OTC derivatives make this task far more difficult. While the government is taking measures to address the systemic threat OTC derivatives pose, these efforts may soon prove ineffective. The knowledge of derivatives traders and the rapid change in financial innovation make regulating this market a daunting task.²⁴⁰ But this Note's proposal of more stringent disclosure and reporting requirements can help increase market transparency which, in turn, makes regulating the OTC market easier.

237. See *supra* note 116 and accompanying text (stating Congress's intent to exempt end-users from the mandatory clearing of swaps).

238. See *supra* Part VI.A.

239. See Greenberger Letter, *supra* note 206.

240. See *e.g.*, Anabtawi & Schwartz, *supra* note 229.