The Door Is Still Ajar: Analysis and Shortcomings of the CFTC's Final Rule on the Mandated Clearing of Certain Derivatives

Todd Barnet

Follow this and additional works at: https://via.library.depaul.edu/bclj

Recommended Citation
Available at: https://via.library.depaul.edu/bclj/vol12/iss2/2
The Door is Still Ajar: Analysis and Shortcomings of the CFTC'S Final Rule on the Mandated Clearing of Certain Derivatives

Todd Barnet*

CONTENTS

I. INTRODUCTION .............................................. 147
II. BACKGROUND ................................................ 149
   A. Basic Overview of Derivatives .................. 149
   B. Over-the-Counter Derivatives .............. 151
   C. Credit Defaults Swaps ....................... 152
III. OTC DERIVATIVES AND CONGRESSIONAL RESPONSE .. 153
   A. The Role of OTC Derivatives in the Financial Crisis ............................................. 153
   B. Congressional Response: Dodd-Frank and Clearinghouses ........................................ 156
      1. Clearinghouses ..................................... 156
      2. Dodd-Frank ......................................... 158
IV. THE FINAL RULE ............................................ 159
   A. Abstract and Background ....................... 160
   B. Comments on the Notice of Proposed Rulemaking .................................................. 160
   C. Final Rules ........................................... 161
V. ANALYSIS .................................................... 165
   A. Section 50.2: Treatment of Swaps Subject to a Clearing Requirement ............ 166
   B. Section 50.4: Classes of Swaps Required to Be Cleared ........................................ 166
   C. Section 50.10: Prevention of Evasion of the Clearing Requirement and Abuse of an Exception or Exemption to the Clearing Requirement ............. 168

I. INTRODUCTION

The financial crisis of 2007–2012 was an almost unprecedented American economic depression, the impacts of which will be felt for years to come. In the search for the cause of such catastrophic events,

* Associate Professor of Legal Studies, Pace University; J.D., Brooklyn Law School; A.B., University of Southern California.

147
over-the-counter (OTC) derivatives and, more specifically, credit default swaps (CDS) have been a key focal point of the crisis aftermath. A critical element of the Dodd-Frank bill has focused on reducing the inherent risk in these OTC derivative transactions in an attempt to eradicate some of the interconnectedness in our financial system that lead to the domino effect of Bear Stearns and Lehman Brothers collapsing and the American Insurance Group (AIG) needing a massive federal bailout to avoid a similar fate.¹ One of the central tools to that end is the emergence of a clearing requirement for certain types of OTC transactions.²

The promulgation of this clearing requirement culminated in the U.S. Commodity Futures Trading Commission’s (CFTC) issuance of a Final Rule on the requirement in December 2012.³ Most entities that transact in OTC derivatives were required to come into compliance with the Final Rule by February 11, 2013; some were given an extension until March 11, 2013.⁴ As the rule is now in full effect, this paper will analyze some of the rule’s shortcomings and propose solutions to impending problems.

Several papers have argued the merits of the clearinghouse model as an adequate solution to such a catastrophic issue. This paper intends to focus on the adequacy of the Final Rule promulgated by the CFTC on December 13, 2012, rather than weigh the pros and cons of a general clearinghouse model, which is the approach the CFTC has already clearly taken. Specifically, this paper will critique the potential gaps in three of the six regulations the Final Rule enacted that could undermine the effectiveness of the entire Rule. First though, it is important to understand how we got here and why OTC derivatives, and CDSs more specifically, have been so hotly targeted for regulatory change.

Part II of this paper discusses the broad impacts of the financial crisis beginning in 2007 and ties the roots of this crisis to the de-regulation of the late 1990s and early 2000s. Part II also explains what derivatives and CDSs are and the inherent risks they pose. Part III discusses the Dodd-Frank Act’s proposed solutions, namely the afore-

---

². Dodd-Frank § 723(h)(1)(A).
⁴. Id.
mentioned clearing requirement. Part III also describes the workings of a clearinghouse in general and attempts to explain why the CFTC chose this solution. Part IV provides an analysis of the Final Rule. Finally, Part V critiques the potential holes in the Final Rule and offers some potential solutions.

II. BACKGROUND

By almost any measure, the financial crisis of the late 2000s was one of the deepest and most widespread depressions in U.S. economic history. As early as 2009, before the scope of the crisis was even fully understood, some analysts were already pegging the crisis as the worst since the Great Depression. Even today, the future of the American economy remains murky with little certainty as to when a full recovery will be complete. Many people have spent the past few years with an eye towards the past in an attempt to find a root cause of the crisis in order to eradicate from our system the type of financial virus that could cause such harm and, perhaps, to find a scapegoat. Soon after the economic swell began, credit derivatives became the primary scapegoat.

Before understanding why these financial products became the poster child for an unchecked Wall Street, it is important to first understand what derivatives are and how they function. An understanding of the basic nature and power of derivatives makes it possible to see how this particular financial instrument was capable of creating such a cataclysmic effect on the global economy.

A. Basic Overview of Derivatives

A derivative is a financial instrument that allows its owners to bet "on the direction they believe financial markets will move, without ever needing to own tangible assets." The purpose of using derivatives is to limit one's risk, often referred to as exposure, to various events, such as price fluctuations. For example, a farmer who wants

---


9. Id.
to protect himself against a fluctuation in corn prices may hedge himself via a bet on the future price of corn. Thus, a derivative is simply a financial product whose “value is ‘derived’ from underlying assets like mortgages, stocks, bonds, or commodities” like corn.\textsuperscript{10} By some estimations, derivatives have existed for thousands of years.\textsuperscript{11} The use of derivatives in American history has been traced back to the mid-1800s, when farmers would hedge price fluctuations in various kinds of crops to protect themselves from potentially exorbitant losses.\textsuperscript{12}

An important distinction between a derivative product and other financial products is that the purchaser of a corn future, for instance, does not need to own any underlying tangible asset; the purchaser is simply betting against future price changes or some other market event. Specifically, credit derivatives are products that transfer the risk of non-repayment on a credit obligation to the purchaser of the derivative.\textsuperscript{13} The original party holding the credit risk, a retail bank for instance, packages the risk into a “product” and sells it to a party, perhaps a financial institution, which in return provides the bank with a semi-regular fee.\textsuperscript{14} At the heart of this transaction is a shell game; no risk is eliminated via the transfer, rather, it is just moved from one party who values the risk less than the other party.\textsuperscript{15}

The critical element to understand in this credit derivative transaction is that the shifting enables the parties to “detach[] the risk imbedded in an asset from the expected returns from holding the asset, [thus] enabling the market to freely trade credit risk completely separate from assets.”\textsuperscript{16} The purchaser has assumed the risk of non-payment.\textsuperscript{17} That is, the purchaser has acquired the exposure of a commodity to the underlying market, which affects the value of the underlying asset.\textsuperscript{18} For example, when Bank A buys a securitized bundle of mortgages from a lending institution, Bank A is directly susceptible to fluctuations in the housing market without owning a house or a mortgage directly.\textsuperscript{19} While a useful and powerful tool to hedge

\textsuperscript{10} Id. at 40.
\textsuperscript{12} Greenberger, supra note 1, at 128.
\textsuperscript{13} Nathaniel G. Dutt, Current United States Credit Default Swap Regulatory Initiatives: A New World Standard or Just a Ploy?, 16 ILSA J. INT’L & COMP. L. 169, 171 (2009).
\textsuperscript{14} Id. at 172.
\textsuperscript{15} Id. at 171.
\textsuperscript{16} Id. at 172.
\textsuperscript{17} Moran, supra note 8, at 41.
\textsuperscript{18} Dutt, supra note 13, at 172.
\textsuperscript{19} For more on securitization of mortgages, see Griffith, supra note 11, at 1165–66.
against risk, the lack of regulation in place to check these types of bets was a significant contributor to the demise of multiple financial institutions.

B. Over-the-Counter Derivatives

There are two primary markets for derivatives transactions: exchange trading and over-the-counter (OTC) trading. The OTC derivatives market is made up of "bilateral" contracts between dealers, and contracting parties accordingly bear all of the risks inherent in their transaction, including both market risk and counterparty risk.\(^\text{20}\) That is, each party is subject to the risk that market forces will affect the value of their trade (be it the housing market or any other underlying forces) and that the other party in the contract, the counterparty, cannot make the agreed, contractual payments. This latter risk is the critical element of derivatives transactions that the CFTC's final rule on mandatory clearing of certain types of derivatives focuses on, as will be discussed at length in Part IV of this paper.\(^\text{21}\)

OTC transactions allow derivatives traders to greatly increase their leverage.\(^\text{22}\) They do so by allowing traders to enter a transaction that simulates the returns of a party owning a certain stock, for instance, without requiring purchase of the stock and often requiring little to no collateral.\(^\text{23}\) By putting forth only a small percentage of the financial allocation required to purchase stock, these traders can be exposed to the same potential gains and losses as traditional stock market participants: a so-called "naked call."\(^\text{24}\)

While it is important to understand the steps taken to mitigate this risk, it is also critical to understand what caused the risk to be so pervasive and impactful on the broader financial market. In December 2000, the Commodity Futures Modernization Act of 2000 (CFMA) was signed into law by President Clinton.\(^\text{25}\) One of the principal effects of the CFMA was to "remove[ ] OTC derivatives transactions . . . from all requirements of exchange trading and clearing under the


\(^{23}\) Id.

\(^{24}\) Id.

CEA [Commodity Exchange Act] so long as the counterparties to the swap were eligible contract participants," which basically required only that each party had more than $10 million in total assets or was trading for risk management purposes.26 Additionally, there were many provisions in the Commodity Exchange Act (CEA) that specifically did not then apply to the OTC derivatives market, including disclosure, clearing requirements, capital adequacy requirements, and more, all of which were in place to guarantee some oversight and stability in these types of transactions.27 By any measure, the CFMA represented broad deregulation of the OTC derivatives market. One other significant aspect of this deregulation was to allow "excessive speculation," setting the stage for the type of massive, over-leveraged market that was doomed to fail.28 Estimates show that the OTC market had a notional value of $596 trillion at the time of the crisis.29

C. Credit Default Swaps

Credit default swaps (CDS) are a type of OTC derivative used as "quasi-insurance policies on debt instruments . . . to guard against credit losses from default."30 CDSs are essentially contracts to transfer the risk of bad credit events, which often amount to a default in some variety or another depending on the underlying asset.31 More broadly, these bad credit events, often referred to simply as credit events, are any "negative development relating to the specified reference debt obligation, such as a failure to pay under the obligation or the bankruptcy of the entity that issued the reference obligation."32

Often, CDSs would be used as guarantees on collateralized debt obligations (CDO)33 or "contractual instruments intended to insure against losses . . . when a particular bond or security goes into default."34 CDOs were basically new financial instruments created by bankers and were the result of multiple steps of securitization.35 The first step was the creation of mortgage-backed securities, which basically turn underlying mortgages, with their "predictable income

26. Greenberger, supra note 1, at 142.
27. Id.
28. Id.
29. Id. at 143–44.
30. Moran, supra note 8, at 41.
31. Dutt, supra note 13, at 172.
33. Greenberger, supra note 1, at 145.
34. Moran, supra note 8, at 41.
35. Griffith, supra note 11, at 1166.
stream,” into tradable securities. Importantly, this allowed the proliferation of the housing market risk to spread throughout broad swaths of the financial system. As sundry publications have detailed, these security packages, comprised of high, medium, and low credit ratings, would then be repeatedly re-bundled in an effort to increase the credit rating. This second, and sometimes third or fourth, repackaging would create what is known as a CDO. Notably, almost always, the debtor, who holds the underlying asset, is not made privy to the transaction, which speaks to the great and unknown risks that these transactions were subjected to because the “primary purpose of CDSs is to make it easier for banks to sell complex debt securities to investors[.]”

Credit default swaps were, at first, a simple insurance mechanism to protect CDO owners against loss. However, once defaults began en masse in the housing market, CDOs began to fail, and the issuers of credit default swaps were faced with tremendous payment obligations. In layman’s terms, this is akin to an insurance company forced to pay out claims after a tremendous natural disaster but only if the natural disaster spread throughout the entire United States. Coupled with the gap in regulation mentioned earlier, it is easy to see how the proliferation of these derivatives contracts was able to sink the U.S. economy.

III. OTC DERIVATIVES AND CONGRESSIONAL RESPONSE

A. The Role of OTC Derivatives in the Financial Crisis

Common understanding now points to the OTC derivatives market as one of the central causes of the economic collapse of the late 2000s. When the U.S. housing market, long “inflated by a combination of government policy, unscrupulous lending practices, and financial engineering,” finally crashed in 2007, the financial collapse began. As discussed in the last section of this paper, the impetus for the power of derivatives to nearly bring down an entire economy is a

36. Id. at 1165.
37. Id. at 1166.
38. Id.; see also MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).
39. Dutt, supra note 13, at 175.
40. Moran, supra note 8, at 41.
41. Greenberger, supra note 1, at 146.
42. Id. at 147; see also Ben Protess, Banks Face New Checks on Derivatives Trading, N.Y. TIMES DEALBOOK BLOG (Jan. 3, 2013, 11:07 AM), http://dealbook.nytimes.com/2013/01/03/banks-face-new-checks-on-derivatives-trading/?_r=0 (suggesting the derivatives market blew up and largely caused the 2008 crisis).
43. Griffith, supra note 11, at 1164 (internal citations omitted).
result of their innate connection to the housing market. The securitization of mortgages—often sub-prime mortgages, which come with a higher risk of default—and the successive repackaging of these mortgages to generate higher credit ratings meant that the insurance on these contracts was increasingly important. This insurance, of course, came in the form of credit default swaps. However, because these types of OTC derivatives were “pegged to the economic performance of an overheated . . . housing market, the sudden collapse of that market triggered under-capitalized OTC derivative guarantees,” and the demise of the housing market spelled doom for the massive derivatives market.

Even those who do not find OTC derivatives to be the central cause of the collapse understand that their use intensified the crisis. Zachary Gubler discusses two principal ways in which OTC derivatives “exacerbated” the crisis: first, by allowing derivatives dealers to assume tremendous exposure to CDOs and, second, by contributing to “bank-like runs.” One example of the first intensification factor that Gubler points to is American International Group Financial Products (AIGFP), an arm of the American Insurance Group (AIG) that dealt largely in credit derivative transactions. The much-publicized bailout of AIG is all the indication one needs to understand that the lack of regulation, and what Gubler calls “faulty risk modeling,” underlying these transactions was a disastrous cocktail of under-appreciation for the power of derivatives.

Gubler also discusses the impact of these transactions on banks, namely Bear Stearns, in a “bank-like run” scenario, which can be equated to a sort of spiraling downfall. First, investors were shielded from understanding the bank’s exposure to these transactions based on Bear Stearns’ lack of transparency and “institutional complexity.” Next, once news of the bank’s financial troubles became known, their counterparties attempted to reduce their exposure to the bank. It is important to keep in mind here that because these transactions were OTC, not exchange-based, they were severely under-regulated, and Bear Stearns’ counterparties directly bore the risk of Bear

44. Id. at 1165.
45. Greenberger, supra note 1, at 128.
46. Gubler, supra note 20, at 87.
47. Id.
48. Id.
49. Id.
50. Id. at 88.
51. Gubler, supra note 20, at 88.
52. Id.
Stearns' demise. The pullback of Bear Stearns' counterparties had the effect of decreasing Bear Stearns' liquidity, thus "accelerating its failure."53

As the Bear Stearns example and federal bailouts more broadly indicate, there can be no question that the implosion of these largely unregulated transactions caused an unforeseeable and possibly unprecedented impact in the U.S. financial market. In response, the Financial Crisis Inquiry Commission (FCIC) was appointed to inquire into the causes of the late 2000s crash.54 The FCIC issued a report entitled, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States."55 The report, in part, analyzed the proliferation of derivatives and pointed to their widespread use as a result of the removal of "virtually all regulation or oversight" in the CFMA.56 Because of the unregulated and tremendous exposure-collateral gap spurred by the housing boom of the late 1990s and early 2000s, banks and insurance firms began to deal in large quantities of these products with minimal, if any, financial safeguards in place.57 AIG is an example of a firm that was allowed to "accumulate a [$500 billion] position in credit risk through the OTC market without being required to post one dollar's worth of initial collateral or making any other provision for loss."58

Further exacerbating this ticking time bomb was the concentration of the massive market for these types of transactions within an extremely small sector of firms. In fact, the FCIC report found that 97 percent of the notional amount of OTC derivatives were traded by only five institutions: JP Morgan Chase, Citigroup, Bank of America, Wachovia, and HSBC.59 To put this in perspective, the same report found that the value of underlying assets for credit default swaps transactions reached $58.2 trillion in 2007, almost a ten-fold increase since 2004.60

53. Id.
55. FIN. CRISIS INQUIRY COMM'N, supra note 22.
56. Id. at 48.
57. Id. at 50.
58. Id.
59. Id.
60. FIN. CRISIS INQUIRY COMM'N, supra note 22, at 50.
Some have argued that the financial crisis was largely a result of investor panic.\textsuperscript{61} It is quite possible that this panic was intensified because, as the FCIC report suggests, all eyes were on the derivatives market while the risks and worst-case scenarios were a complete mystery.\textsuperscript{62}

Some of the numerical results of the various post mortems of the financial crisis are stunning, even with a few years perspective. The U.S. Department of the Treasury released a report about their response to the crisis in April 2012 with some stunning statistics.\textsuperscript{63} From 2007 to 2009, 8.8 million jobs were lost.\textsuperscript{64} Additionally, households lost a total of $19.2 trillion in wealth, and real GDP fell more than five percent from its pre-recession peak.\textsuperscript{65} These are astounding numbers, and there is little doubt that the unregulated OTC derivatives market is largely to blame.\textsuperscript{66}

B. Congressional Response: Dodd-Frank and Clearinghouses

To no one’s surprise, lawmakers attempted to respond swiftly and powerfully to the financial crisis with sweeping legislation intended to put some teeth back into the regulation of financial products and ensure that our nation’s economy could not be undone by a handful of institutions making risky, under-collateralized bets. The primary mechanism for this change was the Dodd-Frank Wall Street Reform and Consumer Protection Act, created “to overhaul the United States financial regulatory structure in the aftermath of the 2008-2009 financial meltdown.”\textsuperscript{67}

1. Clearinghouses

One of the focal points of Dodd-Frank has been the use of clearinghouses in OTC derivatives transactions. Before delving into the substantive law, it is first important to understand what a clearinghouse

\begin{itemize}
\item \textsuperscript{62} FIN. CRISIS INQUIRY COMM’N, supra note 22, at 51 (suggesting that the financial crisis was an unknown battlefield).
\item \textsuperscript{64} Id.
\item \textsuperscript{65} Id.
\item \textsuperscript{67} Robert M. Jaworski, There’s a New Kid on the Block: What You Need to Know About the Bureau of Consumer Financial Protection, 266 N.J. LAW. 14, 14 (2010).
\end{itemize}
does and does not do. Clearinghouses have been in existence as a mechanism to control the derivatives market since the late 19th century.\(^\text{68}\) A clearinghouse acts as "the buyer to every seller, and the seller to every buyer" in a given contractual transaction.\(^\text{69}\) So, for example, when Bank A agrees to a credit default swap transaction with Insurance Company B in a world without clearinghouses, the Bank and the Insurance Company are each other's counterparty. The function of a clearinghouse is that it becomes the counterparty to each contract, thus, bearing the risk of one party defaulting and subsequently decreasing that risk to the non-defaulting party.\(^\text{70}\) This can be an invaluable mechanism to prevent excessive counterparty risk, the downside of which is easily seen from the aforementioned Bear Stearns example.

Clearinghouses are also aptly termed centralized counterparties.\(^\text{71}\) By acting as a sort of go-between for contracting parties and handling the contractual payments for their members, clearinghouses help manage counterparty risk.\(^\text{72}\) Thus, members to the clearinghouse "no longer face the risk that counterparties will default" and are additionally benefitted by the clearinghouse acting "as a guarantor for transactions executed on the clearinghouse platform."\(^\text{73}\) However, that is not to say that they are without risk themselves. Just like in the non-clearinghouse model in which each party's potential to default imposes risk on their counterparty, a clearinghouse may also default or become overburdened. This danger requires clearinghouses to employ their own risk-management tactics and ensure their capability to make good on their payment obligations to all transactions.\(^\text{74}\)

Therefore, while clearinghouses mitigate one type of risk, they also create another. On the one hand, clearinghouses insulate a given member from "the risk that another member will default on obligations cleared and settled on the clearinghouse platform."\(^\text{75}\) On the other hand, however, clearinghouses "concentrate default risk," meaning that the bankruptcy of a single clearinghouse could have the

---


\(^\text{69}\) Id.

\(^\text{70}\) Id. at 45–46.


\(^\text{72}\) Id.


\(^\text{74}\) Id.

\(^\text{75}\) Id.
devastating impact of the default of many counterparties. Therefore, systemic risk remains pervasive, even in a clearinghouse model. As such, many papers have focused on the management and oversight policies a clearinghouse should adopt. This paper does not explore that particular aspect of clearinghouses, but Part V does address some of the shortcomings of the clearinghouse-focused model promulgated in the CFTC's final rule on mandatory clearing.

2. Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act was one of the most massive regulatory overhauls of the last decade. The bill was signed into law by President Obama on July 21, 2010. The buildup to this ultimate approval was rife with staunch opposition from Wall Street, where firms dedicated three years and hundreds of millions of dollars to fighting the bill. Whether one argues that the bill went too far or not far enough, it is massive in scope and attempts to impose greater regulations on a wide swath of financial activity.

The basic structure of the bill is divided into sixteen provisions, Title I through Title XVI. Each section works more or less as a framework for further rulemaking, often delegated to specific federal agencies. The critical section for the purposes of this paper is Title VII, also known as the Wall Street Transparency and Accountability Act. This section primarily deals with regulating OTC transactions. Title VII is designed to create a new framework for oversight into the swaps market and delegates powers to the CFTC and SEC to that end. So while Congress created the framework for the overall legislative reform, it is the CFTC and SEC that are charged with actually creating the specific rules and regulations regarding OTC derivatives. As has been discussed several times, this power was wielded in the CFTC's final rule on mandatory clearing for certain types of transactions.

76. Id. at 695.
77. See, e.g., Griffith, supra note 11, at 1153.
80. See id. at 1641–1802.
As stated in the final rule, which will be discussed in further detail in Part IV, "[c]learing is at the heart of the Dodd-Frank financial reform." Responding to the tremendous risks when market participants could not accurately estimate their counterparty's exposure to market movements and other events, central clearing emerged as a globally accepted quasi-solution. In the absence of central clearing, market participants bear their own risk of default by their counterparty. Therefore, Title VII, and its creation of a new regulatory framework for swaps, hinged largely on the requirement that swaps are cleared by a derivatives clearing organization (DCO). As the final rule states:

The CEA [Commodity Exchange Act], as amended by Title VII, now requires a swap: (1) To be cleared through a DCO if the Commission has determined that the swap, or group, category, type, or class of swap, is required to be cleared, unless an exception to the clearing requirement applies; (2) to be reported to a swap data repository (SDR) or the Commission; and (3) if the swap is subject to a clearing requirement, to be executed on a designated contract market (DCM) or swap execution facility (SEF), unless no DCM or SEF has made the swap available to trade. As justification for this change, the Commission thought that a clearing requirement would reduce counterparty credit risk as well as offer an “organized mechanism for collateralizing the risk exposures posed by swaps.” In layman's terms, the idea is that proper collateralization, plus reduced counterparty risk, equals no more AIGs. While the above excerpt offers a simple, high-level overview of Title VII, we now turn to the Final Rule for more detail.

IV. The Final Rule

On December 13, 2012, the CFTC published 77 FR 74284, a final rule in the Federal Register entitled, "Clearing Requirement Determination Under Section 2(h) of the [Commodity Exchange Act]; Final Rule." The rule became effective on February 11, 2013. The rule is organized into six sections: background, comments on the notice of proposed rulemaking, the final rule itself, implementation, cost bene-

83. Id. at 74,285.
84. Id.
85. Id.
86. Id.
88. Id.
89. Id.
90. Id. at 74,284.
fit considerations, and "related matters." This paper will provide a brief overview of the rule's overall framework and analyze more deeply some of the most critical sections.

A. Abstract and Background

The rule begins with a summary detailing its establishment of a clearing requirement for certain classes of credit default swaps and interest rate swaps under new section 2(h)(1)(A) of the Commodity Exchange Act. Additionally, regulations to prevent evasion of the clearing requirement are discussed.

Following this abstract, the final rule discusses the original clearing requirement proposal. A Notice of Proposed Rulemaking (NPRM) was issued on August 7, 2012, and a window was open for thirty days for comments on the proposed rulemaking. The rule then provides a high-level summary of the financial crisis, the role of unregulated OTC derivatives in the crisis, as well as some of its root causes. Relying on the aforementioned report from the Financial Crisis Inquiry Commission, significant blame is attributed to OTC derivatives and to credit default swaps in particular. This section of the rule then continues to discuss the central role of clearing in Dodd-Frank and the global acceptance of centralized clearing as an appropriate regulatory reaction to the worldwide financial crisis.

B. Comments on the Notice of Proposed Rulemaking

Next, the rule reviews the thirty-day public comment period after the NPRM was published. A total of thirty-three comments were received, and the Commission met with "clearinghouses, market participants, trade associations, public interest groups, and other interested parties." Much of this section is simply a response by the CFTC to the numerous comments and can be seen as a simple assurance that the comments were duly noted.

91. Id.
93. Id.
94. Id.; FIN. CRISIS INQUIRY COMM'N, supra note 22, at 56.
96. Id. at 74,287.
97. Id.
The comment section also discusses the five factors in a “determination analysis” for a given swap—that is, what the CFTC considers in making a clearing determination. These factors are:

1. The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data;
2. The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
3. The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the DCO available to clear the contract;
4. The effect on competition, including appropriate fees and charges applied to clearing; and
5. The existence of reasonable legal certainty in the event of the insolvency of the relevant DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

These are known as the five statutory factors and have become an important piece of the regulation. The rule then discusses each factor in turn and proceeds to analyze specifically the types of transactions (interest rate swaps and CDSs) that are subject to the clearing mandate.

C. Final Rules

The aptly titled Final Rules section of the Final Rule is, quite obviously, the heart of the publication. Under section 2(h)(2), the Commission’s six regulations were officially adopted. This paper will review each of these in turn, as they are the crux of the CFTC’s action. Then, this paper will discuss the other sections of the final rule. Finally, Part V will address some shortcomings and potential pitfalls of the regulations.

First, Regulation 50.1 was adopted, defining a few key terms. The first term defined is “business day,” which excludes Saturday and Sunday. The second term is “day of execution.” Because of the global nature of the swaps community, there were often seemingly simplistic difficulties in determining which day a swap transaction oc-

98. Id. at 74,292.
99. Id.
100. Clearing Requirement Determination Under Section (2)h of the CEA, 77 Fed. Reg. at 74,292.
101. Id. at 74,294.
102. Id. at 74,314.
103. Id.
104. Id.
curred, which is critical because of the same-day requirement for submitted swaps to a DCO.\textsuperscript{106} For instance, it would be unclear whether a transaction completed Monday at 1 PM in New York with a broker in London would fall on Monday or Tuesday. That is because the London business day would “close” after 4 PM, and ordinarily the swap would be registered as occurring on Tuesday. This clearly is an improper result. Therefore, the new definition of “day of execution” is defined as the “calendar day of the party to the swap that ends latest, giving the parties the maximum amount of time to submit their swaps to a DCO while still requiring such submission on a same-day basis.”\textsuperscript{107} In response to a comment, the Commission clarified that there is no prohibition on late-day submission of swaps.\textsuperscript{108}

Next, the Commission adopted Regulation 50.2, entitled, “Treatment of Swaps Subject to a Clearing Requirement.”\textsuperscript{109} The crux of this rule is that all persons, other than those who use the section 50.50 exception, must submit their swaps for clearing by a DCO “as soon as technologically practicable and no later than the end of the day of execution.”\textsuperscript{110} Quite clearly, this is to ensure that swaps are submitted to DCOs in a timely fashion, minimizing risk and ensuring compliance with the overall goals of the clearing requirement.\textsuperscript{111} A few interesting points of clarification were raised in comments to which the CFTC responded. First, the Commission clarified that non-clearing members satisfy their duties by submitting the swap to their Futures Commission Merchant (FCM) clearing member.\textsuperscript{112} Also, the International Swaps and Derivatives Association (ISDA) raised a question as to the status of foreign entities.\textsuperscript{113} The Commission expressly exempted “foreign governments, foreign central banks, and international financial institutions” from section 2(h)(1) of the CEA.\textsuperscript{114} Because of the continued reliance by the Commission on issues already addressed by the end-user exception rulemaking, there is a significant amount of overlap between that rule and the rule in question. As such, Part V of this paper will discuss both and the shortcomings they present.

\begin{thebibliography}{114}
\bibitem{106} Id.
\bibitem{107} Id.
\bibitem{108} Id.
\bibitem{109} Id.
\bibitem{110} Clearing Requirement Determination Under Section (2)h of the CEA, 77 Fed. Reg. at 74,329.
\bibitem{111} Id. at 74,314.
\bibitem{112} Id.
\bibitem{113} Id. at 74,315.
\bibitem{114} Id.
\end{thebibliography}
The next regulation is section 50.3: "Notice to the Public." This regulation is relatively straightforward and simply requires the participating DCOs to post a list of swaps they will accept for clearing and to indicate which swaps require mandatory clearing on their website.

Section 50.4: "Classes of Swaps Required To Be Cleared" is a more controversial regulation. By limiting the classes of swaps covered by the mandatory clearing requirement to a relatively conventional group of four interest-rate swaps and two credit default swaps, the Commission attempted to lighten the burden on counterparties in quickly determining whether a particular swap requires clearing or not. While ensuring the speed and ease of these transactions is an admirable goal, the focus on easing this burden as a critical factor for which swaps should be cleared creates other issues. The Commission also makes clear, in a response to a comment by TriOptima, that it will not require parties to disentangle swaps that require partial clearing, as it is not trying to foster structuring swaps in a particular manner so long as the swap serves a legitimate business purpose. One other important piece of this regulation that the Commission outlines is that in the event of ownership changes—where a swap is not subject to a clearing requirement at the time of execution—it may become subject to clearing because it has transferred owners either via novation, exchange, transfer, or conveyance. This is a critical point of clarification by the Commission and will also be discussed in Part V.

The next regulation, section 50.5: "Clearing Transition Rules," simply exempts some swaps entered into prior to the enactment of Dodd-Frank from clearing, despite being of a class regulated under section 50.4. The penultimate regulation is section 50.6: "Delegation of Authority[.]" This regulation simply clarifies that the power to determine whether a swap falls within a section 50.4 class rests with the Director of the Division of Clearing and Risk or his/her designee.

Finally, there is Regulation 50.10: "Prevention of Evasion of the Clearing Requirement and Abuse of an Exception or Exemption to
the Clearing Requirement.”\textsuperscript{124} This is an extraordinarily important regulation because it gets to the very heart of the fundamental question here: can financial institutions and others simply change the basic nature of their swaps so they do not have to be cleared? This is a deeply troubling prospect for the CFTC, as well as the Legislative and Executive branches that stand behind Dodd-Frank, as Title VII is one of the most critical aspects of the Dodd-Frank Act. Section 50.10 prohibits “evasions of the requirements of section 2(h) of the CEA and abuse of any exemption or exception to the requirements of section 2(h).”\textsuperscript{125} More specifically, this regulation makes it “unlawful for any person to knowingly or recklessly evade, participate in, or facilitate an evasion of any of the requirements of section 2(h).”\textsuperscript{126}

While the rule itself is certainly important, what is more interesting in this regulation is the approach that the Commission articulates it will take in dealing with potential violations. First, they adopt a “principles-based approach” and outright decline to put a bright-line rule regarding evasive or abusive conduct in place, therefore requiring a case-by-case approach.\textsuperscript{127} Next, the Commission addressed a query from the ISDA regarding legitimate business purposes.\textsuperscript{128} ISDA suggested that a business’ decision to enter into a swap that does not require clearance “because [the uncleared swap] is cheaper, or free of unwanted aspects of clearing or trading” should be deemed legitimate.\textsuperscript{129} The Commission’s response was to state that an entity “may have legitimate business purposes for entering” these kinds of transactions and that it “is not, in and of itself, dispositive that the [entity] is acting without a legitimate business purpose in a particular case.”\textsuperscript{130} In limiting this potentially dangerous language, the Commission stated that it would be dispositive if it was shown that the \textit{only} purpose for entering a given swap transaction not requiring clearance was to avoid the clearing requirement but committed itself only to case-by-case future analysis and not a clear standard.\textsuperscript{131} Despite recognizing the uncertainty this stance places upon swap dealers, the Commission neglected to go further.\textsuperscript{132}

\textsuperscript{124} Id.
\textsuperscript{125} Id.
\textsuperscript{126} Id.
\textsuperscript{127} Id.
\textsuperscript{128} Id.
\textsuperscript{129} Id. at 74,318.
\textsuperscript{130} Id. at 74,319 (internal citation omitted).
\textsuperscript{131} Id.
\textsuperscript{132} Id.
THE DOOR IS STILL AJAR

V. ANALYSIS

The central argument of this paper is that the massive OTC derivatives market remains susceptible to several risks despite the formidable effort of Dodd-Frank and the CFTC’s Final Rule on Mandatory Clearing. To that end, this paper will discuss three critical areas of foreseen administrative, cost, and consistency concerns with regard to various aspects of the clearing process. Each of these concerns relates to a specific regulation in the Final Rule, and the three regulations in question are section 50.2 – “Treatment of Swaps Subject to a Clearing Requirement,” section 50.4 – “Classes of Swaps Required To Be Cleared,” and section 50.10 – “Prevention of Evasion of the Clearing Requirement and Abuse of an Exception or Exemption to the Clearing Requirement.” As each of these regulations are discussed in turn, it is important to keep in mind the lessons learned in Part III of this paper about why the clearinghouse model is preferred in the first place.

Before discussing section 50.2, it is important to note one key exception that the CFTC promulgated prior to this Final Rule: the End-User Exception, which has received significant coverage in previous papers.133 This exception was created, in part, to help mitigate the cost of a clearing requirement on certain end-users.134 This exception permits avoidance of the clearing requirement when one party to the swap is not a financial entity, is using swaps to hedge/mitigate commercial risk, and notifies the CFTC generally how it meets its financial obligations relating to non-cleared swaps.135 There was an almost immediate reaction in the press regarding this exception and its implications for the overall efficacy of Title VII.136 While this paper is not meant to discuss the merits of the end-user exception, it is important background information to keep in mind as section 50.2 is discussed. Solely evaluating section 50.2 on its own merits would not adequately portray the potential risks it presents.

---


134. Id. at 127 (discussing the merits of varying scope possibilities for the end-user exemption and then putting forth a proposal on how to properly define an end-user).


A. Section 50.2: Treatment of Swaps Subject to a Clearing Requirement

As discussed in Part IV, section 50.2 provides a general overview of the proper procedure for swaps subject to the clearing requirement. The critical flaw in this regulation is mimicked from the end-user exception. The regulation provides that "foreign governments, foreign central banks, and international financial institutions should not be subject to Section 2(h)(1) of the CEA." While there are doubtless other concerns in play with regard to regulating international institutions and the legality of doing so, there can be no question that this represents a complete exemption for a potentially significant portion of the OTC derivatives market.

On its face, this is the least troublesome of the three regulations. However, when combined with the other two issues below, as well as the end-user exception, one begins to see how a potentially universal regulation becomes less and less comprehensive. Of course, the less comprehensive the regulation, the more susceptible our financial markets remain to the very same risks Title VII was enacted to prevent.

B. Section 50.4: Classes of Swaps Required to Be Cleared

There are two aspects of section 50.4 that warrant consideration here: one of them creating further risk and one of them helping to mitigate potential risks. The former is the lack of a disentangling requirement, while the latter is the status of a clearing requirement in the event of an ownership change on the transaction.

First, the Commission explains its decision to use "basic specifications to identify the swaps subject to the clearing requirement" as an attempt to allow "counterparties contemplating entering into a swap [to] determine quickly as a threshold matter whether or not the particular swap may be subject to a clearing requirement." There is no question this rationalization is centered on cost-prohibitiveness. Were the rule to be complex and require a significant burden on counterparties upon entering every single swap transaction, the transaction costs would be astounding, particularly when considering the tremendous volume of these agreements that institutions typically enter. However, not all swaps fit neatly into one simple bucket. As the Final Rule recognizes, there are ample situations where a swap, under the current regulations, would have one clearable part and one, or several,

---

138. Id. at 74,316.
non-clearable parts.139 Rather than require these swaps to either be disentangled or cleared so long as any portion of them requires clearance, the Commission chose the opposite, simply exempting the swaps from clearance if they require disentanglement.140 All this perverse decision does is incentivize the creation of non-basis, entangled swaps transactions as a surefire way around the clearing requirement, contingent only upon the additional costs of creating the more complicated transaction.

Next, the Commission addressed the implications of an ownership change, whether by "assignment, novation, exchange, transfer or conveyance."141 Simply put, the Commission decided that an outright, permanent clearing exemption for swaps that did not require clearing based on the initial counterparties to the transaction would be inadequate.142 The Commission points out that this would create tremendous incentives to "trade historical swaps."143 Furthermore, this could simply create conduit entities that are exempt from clearing requirements but exist simply to enter into transactions and then assign their rights to a party that would have been subject to the clearing requirement. While the initial transaction and set-up costs may be daunting, there are tremendous opportunities for economies of scale for an entity like this. In this regard, section 50.4 got things right, with one minor exception. The language of the regulation, however, leaves somewhat undecided exactly when a transaction would be subject to a post-initiation clearing requirement. The regulation offers an example regarding a financial entity entering into a transaction with an exempt end-user and the end-user later transferring his ownership rights to a second financial institution; however, this is a plainly obvious case in which the clearing would be required.144 Missing here is some guidance concerning commercial entities because they are the organizations that are in the end-user exception gray area.

139. Id.
140. Id.
141. Id.
143. Id.
144. Id.
Finally, section 50.10(a) intends to "make it unlawful for any person to knowingly or recklessly evade, participate in, or facilitate an evasion of any of the requirements of section 2(h)." 145 Unfortunately, it is not always patently obvious when an entity is avoiding the clearing requirement because of a legitimate business purpose. To that end, the Commission "accepts that a person may have legitimate business purposes for entering into swaps that are not subject to the clearing requirement." 146 However, they also outright refused to "provide a bright-line test of non-evasive or abusive conduct." 147 The Commission also committed itself to a "principles-based" approach and will review questionable conduct on a strictly "case-by-case basis in light of all the relevant facts and circumstances." 148

While there is certainly a tremendous burden of devising a bright-line rule when there are countless types of swaps and situations occurring on a daily basis in this market, it seems as though the administrative burden of not attempting to create a bright-line rule is significant. It is an understood principle that bright-line rules are effective because they are predictive. While there is always the unknown, both in how an agency will rule in a given case and in how they will evaluate a given issue on a repeated basis, a bright-line rule at least invites some sort of consistency. A case-by-case, principles-based analysis is particularly dangerous in the OTC derivatives market because it is so easy to structure transactions that are unique and, therefore, can be distinguished from precedential evasive transactions. The regulation in section 50.10(a) would seem to be actually inviting evasive conduct to a certain degree, at least until some semblance of an enforcement strategy for evasive conduct is delineated. This is particularly true for short-term swaps transactions that would almost certainly be completed prior to the evasive conduct being proven. Unwinding these transactions would likely be cost-prohibitive, and the only real remedy would be a fine of some sort. Unfortunately, there is no guidance for determining whether conduct is evasive or not, except a given entity's belief that it has a legitimate business purpose for avoiding the clearing requirement. As this will almost always come down to cost consid-

145. Id. at 74,317.
146. Id. at 74,319.
148. Id.
erations, the resulting questions will focus on the cost threshold that will create a sufficiently legitimate business purpose, instead of focusing on the conduct itself as a bright-line rule. Neglecting to promulgate some sort of bright-line test for evasive conduct, which notably could always be tweaked in the future, is a fundamental flaw in the Final Rule.

Individually, each of these exceptions or potential loopholes may not be enough to negate the efficacy of the Final Rule. However, working in concert, these exceptions and loopholes leave open the high probability of continued risks that were prevalent in the OTC derivatives market prior to the enactment of the Dodd Frank Act. While there is no question that the mandatory clearing requirement is a step in the right direction, its gaps in coverage are considerable. Thus, the door is still ajar to unchecked OTC derivatives trading crippling the U.S. economy.