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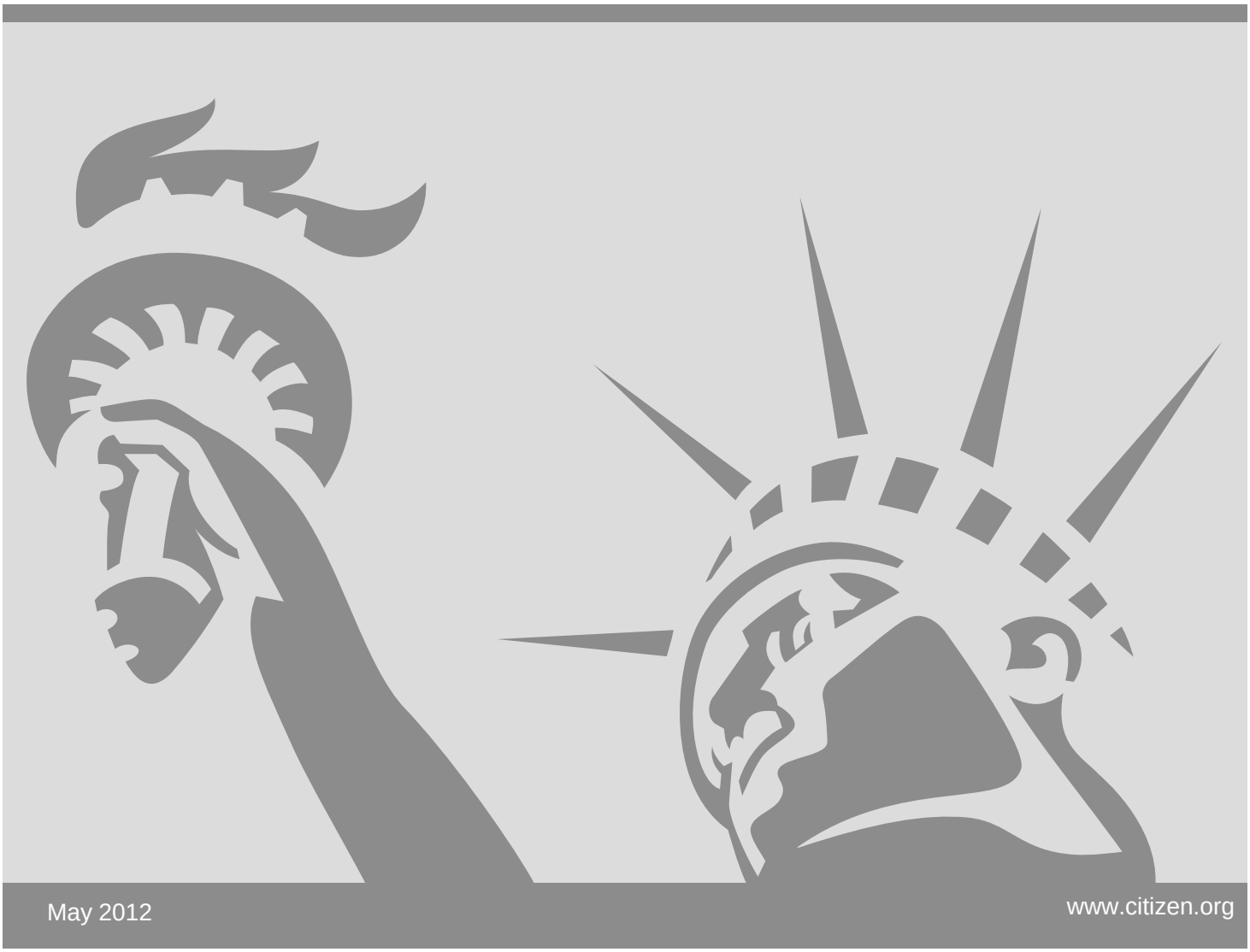

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Forgotten Lessons of Deregulation

Rolling Back Dodd-Frank's Derivatives Rules Would Repeat a Mistake that Led to the Financial Crisis

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> "The sophisticated counterparties that use [over-the-counter] derivatives simply do not require the same protections under the [Commodities Exchange Act] as those required by retail investors."
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> *—President's Working Group on Financial Markets (1999), consisting of Federal Reserve Chairman Alan Greenspan, SEC Chairman Arthur Levitt, Treasury Secretary Lawrence Summers, and CFTC Chairman William J. Rainer*

Although debate continues over some of the root causes of the 2008 financial crisis, there is little dispute that inadequate regulation of derivatives was a major contributor. In admissions of the sort not often heard in Washington, many of the policy makers who supported derivatives deregulation in the late 1990s now acknowledge that they were wrong. They include former President Bill Clinton, former Federal Reserve Chairman Alan Greenspan, and, with more nuance, two former Treasury secretaries.

In the first decade of the 2000s, derivatives issuers used their regulatory exemption to take enormous risks. Derivatives buyers, in turn, drew a false sense of security from the promises laid out in the contracts they purchased. This illusion of security spurred a lending binge that caused housing prices to soar. After the housing bubble burst, the inability of derivatives issuer American International Group (AIG) to make good on its obligations threatened to cause cataclysmic failures among financial institutions. This was largely responsible for prompting the federal government to authorize hundreds of billions of dollars in bailouts. The combination of the financial crisis and a devastated housing market caused a recession from which the nation has yet to recover.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 addressed many of the shortcomings in derivatives oversight. But, now, at least nine bills are pending in Congress that would erode the derivatives' reforms in Dodd-Frank. Some of these bills seek to exempt large classes of derivatives trades from the law's requirements that such trades be transparent, guaranteed by centralized clearing organizations, and accompanied by adequate collateral. Other bills would impose additional burdens on agencies' ability to promulgate financial services regulations, including those regarding derivatives. Each of the seven derivatives bills introduced in the House of Representatives has at least been approved by a committee and three have passed the full House. [See Appendix] The push to roll back the reforms in Dodd-Frank comes amid news that JPMorganChase, the nation's

largest bank, lost at least $2.3 billion—and may eventually lose more than $4 billion—from recent derivatives trades gone awry.[1]

The effort to exclude certain derivatives trades from public oversight is reminiscent of the campaign to deregulate derivatives in the late 1990s. Americans should reject such appeals this time around.

A. History: At the End of the Clinton Administration, the Federal Government Deregulated Financial Derivatives.

Financial derivatives are instruments "that gain or lose value as some underlying rate, price, or other economic variable changes," according to a definition offered by the Congressional Research Service.[2] Although they are commonly tied to commodities, securities, interest rates, or currency values, derivatives can be based on almost anything, including stock prices, energy prices, or even the weather.[3] Derivatives have traditionally been used to manage risk.

A type of derivative called a swap was developed in the 1980s. Participants in swaps agreed to pay one or the other depending on the fluctuation of an underlying variable.[4] Swaps often performed the same economic function as traditional futures, in which a party agreed to buy a commodity or financial instrument on a specified date.[5] But in contrast to futures, which were traded on regulated exchanges and backed by centralized clearinghouses, swaps began as privately negotiated deals between counterparties and were traded on an unregulated "over the counter," or OTC, basis.[6] Unlike traders using regulated exchanges, the participants in over-the-counter trades relied on each another to make good on their deals.

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[1] Dan Fitzpatrick and Gregory Zuckerman, *Three to Exit J.P. Morgan Drew, Others to Depart in Wake of Loss, Which Could Total More Than $4 Billion*, THE WALL STREET JOURNAL (May 14, 2012), http://on.wsj.com/J49m82.
[2] MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, THE COMMODITY FUTURES MODERNIZATION ACT (2003), http://bit.ly/JdYBeK.
[3] *See, e.g.*, Bank for International Settlements (BIS), *Semiannual OTC Derivatives Statistics at End-June 2011* (Nov. 2011), http://bit.ly/3ijsbH.
[4] The Commodity Future Trading Commission defined swaps as "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchanges rates, or prices with payment calculated by reference to a principal base (notional amount)."
[5] For discussion of the similarities of swaps and futures, *see* MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, THE COMMODITY FUTURES MODERNIZATION ACT (2003) (Swaps "serve the same economic purposes and are often interchangeable" with futures) and Michael Greenberger, *Derivatives in the Crisis and Financial Reform* in THE POLITICAL ECONOMY OF FINANCIAL CRISES 4 (Gerald Epstein & Martin Wolfson eds., Oxford University Handbook, forthcoming) http://bit.ly/yVxUxX ("Swaps contained all the features of a futures contract.").
[6] *See*, *e.g.*, GENERAL ACCOUNTING OFFICE, THE COMMODITY EXCHANGE ACT, LEGAL AND REGULATORY ISSUES REMAIN 1 (April 1997), http://1.usa.gov/JbO9tp.

The absence of transparency in over-the-counter trading allowed swaps dealers to command more favorable prices. Trading over the counter also enabled dealers to dodge the licensing and margin requirements imposed by regulated exchanges. But because swaps were similar to futures, they were potentially in violation of the CEA's exchange-trading requirement. This left open the possibility that a court would refuse to enforce a swap if a counterparty questioned its legality.[7] Consequently, swaps dealers sought an exemption to the exchange-trading requirement that would give them legal certainty.[8]

The Commodity Futures Trading Commission (CFTC) in 1989 provided an exemption to the exchange-trading requirement for swaps that were individually negotiated and not marketed to the public. But doubt existed over the CFTC's permission under the CEA to offer this assurance. Congress subsequently granted the CFTC such authority. In 1993, the CFTC stipulated that non-standardized swaps negotiated between two parties would be exempt from the exchange-trading requirement.[9]

Still, questions remained over the legality of many over-the-counter swaps. By the mid-1990s, swaps were becoming increasingly standardized, largely due to master agreements provided by the International Swaps Dealers Association (now the International Swaps and Derivatives Association).[10] "OTC derivatives were now so … standardized that they could be traded electronically on a multilateral basis, thereby exhibiting all of the trading characteristics of traditional exchange traded standardized futures contracts," University of Maryland law professor Michael Greenberger testified to the congressionally appointed Financial Crisis Inquiry Commission (FCIC) in 2010.[11] Greenberger served as director of the CFTC's Division of Trading and Markets in the late 1990s, when questions over regulation of derivatives hung in the balance.

Such standardization raised the prospect that many contracts trading over-the-counter did not meet the terms of the CFTC-issued exemption from the exchange-trading requirement and, thus, could be disallowed.[12] Meanwhile, over-the-counter trading of swaps and other derivatives was soaring. The notional value of over-the-counter derivatives contracts tripled from 1994 to 1997, to more than $28.7 trillion.[13]

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[7] Michael Greenberger, *Derivatives in the Crisis and Financial Reform* in THE POLITICAL ECONOMY OF FINANCIAL CRISES 4 (Gerald Epstein & Martin Wolfson eds., Oxford University Handbook, forthcoming) http://bit.ly/yVxUxX [Hereinafter DERIVATIVES IN THE CRISIS]
[8] *Id.*
[9] *Id*.
[10] *Id.*
[11] Testimony of Michael Greenberger to the Financial Crisis Inquiry Commission (June 30, 2010).
[12] DERIVATIVES IN THE CRISIS, at 5-6.
[13] *Commodity Futures Trading Commission, Concept Release CFR Parts 34 and 35, Over-the-Counter Derivatives*, 63 Fed. Reg. 26114, 26115 (issued May 6, 1998) [Hereinafter CONCEPT RELEASE]. Notional value refers to the target price underlying asset to which a derivative is pegged. For instance a barrel of oil may have a notional

> "I have 13 bankers in my office and they say if you go forward with this, you will cause the worst financial crisis since World War II."
>
> *—Assistant Secretary of Treasury Lawrence Summers to CFTC Chairman Brooksley Born on Born's plan to consider increasing regulation of derivatives (1998)*

Instances of investors experiencing wholly unexpected losses in over-the-counter derivatives trades also were increasing. Many such losses were suffered by ostensibly sophisticated investors who did not grasp derivatives' complexity.[14] Most prominently, Orange County, Calif., lost $1.5 billion in derivative investments in 1994 and was forced to file for bankruptcy. Merrill Lynch, which sold the derivatives to the county, eventually paid $400 million to settle claims that it provided deceptive information.[15] Several other large institutions suffered significant losses in derivatives during the 1990s. In many cases, they were able to recoup part of their losses in litigation against the firms that guided them in their investments.[16]

The rising volume of over-the-counter derivatives trades coupled with lingering doubts over their legality created political tension. CFTC Chairman Brooksley Born favored increasing regulation. Industry instead sought a guarantee that derivatives traded over the counter would be excluded from regulation.

Early in 1998, Born contemplated issuing a request for comments on whether the regulatory system for financial derivatives should be altered. She received a telephone call from Lawrence Summers, who was then an assistant secretary of Treasury. "I have 13 bankers in my office and they say if you go forward with this, you will cause the worst financial crisis since World War II," Summers reportedly said.[17]

value of $100. The potential payments for those trading a derivative pegged to the price of a barrel of oil would be the fluctuation between $100 and its actual price.

[14] *Id.*

[15] E. Scott Reckard and Michael Wagner, *Merrill Lynch to Pay $400 Million to Orange County*, THE LOS ANGELES TIMES (June 03, 1998).

[16] CONCEPT RELEASE, at 26115. In footnote 6 of the Concept Release, the CFTC cited a study listing 22 examples of significant losses in financial derivatives transactions and made reference to a 1997 GAO study that identified 360 substantial losses suffered by end-users.

[17] Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASHINGTON POST (May 26, 2009), http://wapo.st/QIK9f.

> "Diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress."
>
> —*Federal Reserve Chairman Alan Greenspan (1999)*

Born proceeded nonetheless. In May 1998, the CFTC issued a "concept release" seeking comment on whether to alter its largely hands-off approach to financial derivatives trading. The release noted that the over-the-counter derivatives market had experienced "explosive growth" in recent years, with increasing reports of losses, many by investors who did not understand the risks that they were taking.[18]

"Accordingly," the release stated, "the Commission believes it is appropriate at this time to consider whether any modifications … are needed to enhance the fairness, financial integrity, and efficiency of this market."[19]

Born's release was the opening volley in a highly public debate that she would lose in the halls of Washington, D.C., but ultimately win in the eyes of history. On the same day that the CFTC published its concept release, Greenspan, Treasury Secretary Robert Rubin, and Securities and Exchange Commission Chairman Arthur Levitt Jr. issued a joint statement expressing "grave concerns about this action and its possible consequences."[20]

"We seriously question the scope of the CFTC's jurisdiction in this area and we are very concerned about reports that the CFTC's action may increase the legal uncertainties concerning certain types of OTC derivatives," the three wrote.[21] Greenspan, Rubin and Levitt began pushing for legislation that would impose a moratorium on the CFTC's permission merely to consider changing regulation of derivatives. [22]

The collapse of Long-Term Capital Management in September of that year strengthened Born's case. Long-Term was a hedge fund that had used just $2.2 billion of underlying capital to make $1.25 trillion of investments in derivatives.[23] Turmoil in Russia had roiled the market in ways that Long-Term could not survive. The potential cascading effects of Long-Term's impending losses prompted the New York Federal Reserve to broker a deal

[18] CONCEPT RELEASE, at 26119.
[19] *Id*.
[20] Timothy L. O'Brien, *A Federal Turf War Over Derivatives Control*, THE NEW YORK TIMES (May 8, 1998).
[21] *Id*.
[22] *Senate Temporarily Blocks New Rules on Derivative Securities*, THE NEW YORK TIMES (Oct. 7, 1998).
[23] Joseph Kahn and Peter Truell, *Troubled Investment Fund's Bets Now Estimated at $1.25 Trillion* THE NEW YORK TIMES (Sept. 26, 1998).

whereby a consortium of banks bailed out the fund.[24] The banks infused $3.6 billion in capital in exchange for 90 percent of Long-Terms' stock to avert disaster.[25]

Born said in House testimony that the episode "should serve as a wake-up call about the unknown risks in the over-the-counter derivatives market."[26] But lawmakers did not heed the alarm. Instead, they imposed a six-month moratorium on the CFTC's permission to work on derivatives regulation.[27]

Some even took reassurance from the Long-Term episode. Greenspan, for instance, said it confirmed his "spare tire" theory that "diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress."[28]

Greenspan continued to champion deregulation of derivatives unabashedly. "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," Greenspan said in a March 1999 speech. "The fact that the [over-the-counter] markets function quite effectively without the benefits of [CFTC regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives."[29]

Born announced her plan to resign in January 1999 and left office in April.[30] In November of that year, the President's Working Group on Financial Markets—consisting of William J. Rainer (Born's replacement as chairman of the CFTC), Summers (who had become secretary of the Treasury), Greenspan and Levitt—issued a report calling for deregulation of the over-the-counter derivatives market to provide "legal certainty" that various activities were exempt from regulation under the CEA. "The sophisticated counterparties

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[24] Gretchen Morgenson, *Seeing a Fund as Too Big to Fail, New York Fed Assists Its Bailout,* THE NEW YORK TIMES (SEPT. 24, 1998) and Joseph Kahn and Peter Truell, *Troubled Investment Fund's Bets Now Estimated at $1.25 Trillion*, THE NEW YORK TIMES (Sept. 26, 1998). The General Accounting Office would conclude two years later that the actions by the New York Federal Reserve set a dangerous precedent: "Although no federal money was committed to the recapitalization, FRBNY's intervention raised concerns among some market observers that it could create moral hazard by encouraging other large institutions to assume greater risks, in the belief that the Federal Reserve would intervene to avoid potential future market disruptions." GENERAL ACCOUNTING OFFICE, RESPONSES TO QUESTIONS CONCERNING LONG-TERM CAPITAL MANAGEMENT AND RELATED EVENTS 2 (Feb. 23, 2000), http://1.usa.gov/r9dW0D.
[25] FCIC REPORT, at 57.
[26] Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASHINGTON POST (May 26, 2009), http://wapo.st/QIK9f.
[27] *Senate Temporarily Blocks New Rules on Derivative Securities*, THE NEW YORK TIMES (Oct. 7, 1998).
[28] FCIC REPORT, at 58.
[29] *Id.*, at 48.
[30] Press Release, Commodity Futures Trading Commission, Chairperson Brooksley Born Announces Her Intention Not to Seek Reappointment to a Second Term (Jan. 19, 1999), http://1.usa.gov/w3bHcr and Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASHINGTON POST (May 26, 2009), http://wapo.st/QIK9f.

that use OTC derivatives simply do not require the same protections under the CEA as those required by retail investors," the report said.[31]

In December 2000, at the end of the Clinton administration, Congress passed the Commodity Futures Modernization Act (CFMA), which almost fully deregulated OTC derivatives trades. The law exempted contract participants with at least $10 million in assets (signifying that they were sophisticated investors) from exchange trading requirements. The law also preempted state laws that might have otherwise prohibited trades that amounted to gambling.[32] President Clinton signed the bill.

Thus, the "multi-trillion dollar OTC derivatives market was removed from almost all pertinent federal and state enforcement to which trading markets had been subject since the New Deal," Greenberger wrote in 2011. "In effect, almost no law applied to this market" after passage of the CFMA."[33]

B. In the Absence of Regulation, the Derivatives Market Pushed the Financial System to the Brink of Collapse.

Over-the-counter derivatives trading grew dramatically in the years following passage of the CFMA. The notional value of such trades, according to the FCIC, increased from $95.2 trillion in 2000 to $672.2 trillion in 2008—a more than seven-fold increase.[34] By contrast, the entire world's assets in 2008 added up to only $178 trillion, according to the McKinsey Global Institute.[35]

It was possible for the value of derivatives trades to dwarf the entire world's wealth in part because multiple derivative positions could to be taken on the same underlying asset—including by people who didn't even own or agree to buy the asset. This would prove particularly disastrous in the case of credit default swaps, a type of derivative that J.P. Morgan & Co. pioneered in the early 1990s and which insurance company American International Group Inc. (AIG) began selling in about 1998.[36] Credit default swaps "insured" securities, such as collateralized debt obligations (CDOs), which consisted of bundled securities, often including bundled subprime mortgages.

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[31] PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS 16 (NOVEMBER 1999).
[32] DERIVATIVES IN THE CRISIS, at 52.
[33] *Id.*, at 10.
[34] FCIC REPORT, at 48.
[35] MCKINSEY GLOBAL INSTITUTE, GLOBAL CAPITAL MARKETS: ENTERING A NEW ERA (SEPTEMBER 2009), http://bit.ly/yRPfB2.
[36] John Lanchester, *Outsmarted: High Finance vs. Human Nature*, THE NEW YORKER (June 1, 2009), http://nyr.kr/KpGeWM and Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test,* THE WALL STREET JOURNAL (Oct.31, 2008).

Between 2003 and 2007, Wall Street created $700 billion in CDOs that included mortgage-backed securities as collateral.[37] Wall Street managers were hungry for mortgages to fashion new CDOs, for which they profited handsomely. This appetite effectively enabled mortgage lenders to lower their underwriting standards because they believed they could easily unload newly issued mortgages to CDO underwriters. "In effect, the CDO became the engine that powered the mortgage supply chain," the FCIC wrote.[38]

But CDOs and credit default swaps were intertwined, as evidenced by the FCIC's finding that credit default swaps also "fueled the mortgage securitization pipeline."[39] Investors in CDOs gleaned a sense of security by purchasing credit default swaps, which, they believed, would protect them in case their CDOs failed. "Investors became unmoored from the essential risk underlying loans to non-credit worthy individuals" because credit default swaps provided a "seeming safety net to these risky investments," Greenberger wrote.[40]

The worldwide credit default swaps market, according to the FCIC, increased from $6.4 trillion at the end of 2004 to $58.2 trillion by the end of 2007.[41] As Greenberger has noted, that nearly equaled the gross domestic product for the entire world, which in 2007 was about $60 trillion.[42]

The danger posed by credit default swaps was compounded because—unlike most derivatives—they paid off their entire notional value if the underlying asset failed, rather than simply paying according to a fluctuation of an underlying asset value.[43] In a rough analogy, a traditional derivative would have paid the difference between a mortgage and the amount a bank could recoup in a foreclosure sale. But a CDS would pay the entire mortgage value. In practice, the stakes were astronomically greater due to the aggregated nature of the CDOs that credit default swaps insured.

[37] FCIC REPORT, at 129.
[38] *Id.,* at 128.
[39] *Id.,* at xxiv.
[40] DERIVATIVES IN THE CRISIS, at 12.
[41] FCIC REPORT, at 50.
[42] World Bank, http://bit.ly/w6l6pl.
[43] *The Role of Derivatives in the Financial Crisis Testimony, Financial Crisis Inquiry Commission* (June 30, 2010), testimony of Prof. Michael Greenberger, http://bit.ly/yiYNrt.

> "By 2008 our regulatory framework with respect to derivatives was manifestly inadequate."
> —*Former Treasury Secretary Lawrence Summers (2010)*

This danger was further exacerbated because multiple credit default swaps could be purchased on the same underlying asset. Besides using credit default swaps to insure assets they owned, investors could purchase them on assets owned by others. Such arrangements were called "naked credit default swaps" and were the equivalent of buying insurance on a neighbor's house in the hopes that it burns down.[44]

Naked credit default swaps marked an evolution in the purpose of derivatives from their traditional risk-management function to sheer gambling. When the financial crisis struck in 2008, three-to-four times as many naked credit default swaps were in circulation as credit default swaps held by investors who owned the underlying asset.[45] This amounted to many investors buying fire insurance on the same house. If one such house burned down, it would be a very bad day for the company insuring it. Naked credit default swaps left open the possibility that thousands or millions of houses that were insured many times over could, metaphorically, catch fire at once. Such a wildfire would constitute catastrophic day for the insurance company.

But issuers of credit default swaps—particularly AIG—saw no such risk. They viewed the fees they received from credit default swaps as virtually free money because they did not think they would ever have to pay. AIG's models showed only a 0.15 percent chance—1 in 667—that it would ever have to make a single payment on a credit default swap because of the supposed diversity of assets within CDOs.[46]

Because of this misplaced confidence and the absence of regulations to prevent firms from taking undue risks, credit default swap issuers did not maintain adequate reserves in case of disaster. AIG, for instance, took on $500 billion in credit default swap risks without being required to post any collateral, according to the FCIC.[47]

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[44] *See, e.g.*, MICAH HAUPTMAN, PUBLIC CITIZEN, BANKING ON FAILURE: SPECULATORS' USE OF CREDIT DEFAULT SWAPS TO BET ON OTHERS' MISFORTUNE IS UNSEEMLY, DANGEROUS (November 2011), http://bit.ly/xmcKHd.
[45] DERIVATIVES IN THE CRISIS, at 14.
[46] Brady Dennis and Robert O'Harrow Jr., *A Crack in The System*, WASHINGTON POST (Dec. 30, 2008), http://wapo.st/2qmzdG.
[47] FCIC REPORT, at 50.

> "Very strongly held views in the financial services industry in opposition to regulation were insurmountable."
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> —*Former Treasury Secretary Robert Rubin, claiming in 2010 that he had favored greater regulation of derivatives in the 1990s*

Issuers of credit default swaps were permitted to take such risks in part because credit default swaps were not regarded as insurance, even though that is essentially what they were.[48] If credit default swaps were defined as insurance, they would have been regulated by the states. This means they would have been subject to capital reserve requirements and naked credit default swaps would have been illegal.[49]

"Under state insurance law, [naked credit default swaps] would be considered insuring someone else's risk, which is flatly banned," Greenberger wrote. To preserve their non-insurance status, credit default swap dealers advised bond issuers who purchased their products to refer to them as "swaps," not insurance.[50]

The fact that credit default swaps were traded off of regulated exchanges heightened the risk they posed. On regulated exchanges, a clearing facility guaranteed each counterparty against the others. Consequently, the clearing facility required the parties to post adequate collateral. No such protections applied to over-the-counter trades.[51]

Eventually, the housing bubble burst, causing widespread mortgage defaults and corresponding defaults of CDOs. Holders of credit default swaps that insured those CDOs demanded billions of dollars in collateral. But AIG, the largest CDS provider, had nowhere near the capital to satisfy these demands. AIG's inability to make good on its obligations threatened to trigger a chain reaction of failures throughout the financial system that would cripple the economy. [52]

[48] MICAH HAUPTMAN, PUBLIC CITIZEN, BANKING ON FAILURE: SPECULATORS' USE OF CREDIT DEFAULT SWAPS TO BET ON OTHERS' MISFORTUNE IS UNSEEMLY, DANGEROUS (November 2011), http://bit.ly/xmcKHd.
[49] DERIVATIVES IN THE CRISIS, at 12.
[50] *Id.*, at 13.
[51] *Id*.
[52] *See*, *e.g.*, Mary Williams Walsh, *A.I.G. Secures $150 Billion Assistance Package*, THE NEW YORK TIMES (Nov. 10, 2008), http://nyti.ms/IJGNes.

> "Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief.."
> —*Former Federal Reserve Chairman Alan Greenspan (2008)*

This threat prompted Congress to authorize hundreds of billions of dollars in bailouts to prevent a full economic meltdown. AIG has since received at least $140 billion from the government through various programs.[53] To put this figure in perspective, it would fund the SEC for about 105 years and the CFTC for about 683 years.[54]

C. The Policy Makers Who Pushed for Derivatives Deregulation Now Admit They Were Wrong.

Today, there is widespread consensus, even among those who pressed for a laissez faire approach in the 1990s, that creating a regulation-free haven for derivatives was a big mistake.

In 1998, Lawrence Summers warned Brooksley Born that any step toward regulating derivatives would cause the greatest economic disaster since World War II. He also co-signed the report claiming that parties in derivatives trades did not need oversight because they were "sophisticated."

He no longer holds these views. While stating that he could not have foreseen the changes in the derivatives market when he pressed for deregulation, he told the FCIC that "by 2008 our regulatory framework with respect to derivatives was manifestly inadequate."[55]

Robert Rubin, Summers' predecessor as Treasury secretary, co-signed the 1998 statement expressing "grave concerns" about Born's solicitation of opinions on whether to alter derivatives' regulation. He now sees this episode differently. He had agreed with Born's views at the time, he told the FCIC in 2010, but "very strongly held views in the financial services industry in opposition to regulation were insurmountable."[56]

[53] *Id.* and *Where Is the Money: Eye on the Bailout*, PROPUBLICA, http://bit.ly/zIe07l.
[54] U.S. SECURITIES AND EXCHANGE COMMISSION IN BRIEF FY 2013 CONGRESSIONAL JUSTIFICATION (February 2012), http://1.usa.gov/AcnCZH and Christopher Doering, *Obama Seeks $308 Million Budget for CFTC*, REUTERS (FEB. 10, 2012), http://reut.rs/xYcMe7.
[55] FCIC REPORT, at 49..
[56] *Id.*

> "Even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could affect 100 percent of the investments. And indeed 100 percent of the citizens … and I was wrong about that."
> —*Former President Bill Clinton (2010)*

In Rubin's defense, he warned about the risks of unregulated derivatives in his 2003 memoirs.[57] But when critical decisions were being made in the late 1990s, Rubin used his substantial influence to help block regulation, not to insist on it.[58]

Former Federal Reserve Chairman Greenspan, who was perhaps the most ardent advocate for deregulating derivatives, admitted at the onset of the financial crisis in 2008 that he had been "partially" wrong in his view that derivatives did not require more oversight. "Credit default swaps, I think, have serious problems associated with them," he testified. More fundamentally, in repudiation of his longstanding faith in markets' ability to regulate themselves, Greenspan testified, "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief."[59]

Greenspan continued: "The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations, undeniably the original source of the crisis, would have been far smaller and defaults, accordingly, far fewer"[60]

Former President Clinton expressed a mea culpa for allowing himself to be convinced that the regulation of derivatives was unnecessary because only sophisticated investors traded them. "Even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could affect 100 percent of the investments, and indeed 100 percent of the citizens … and I was wrong about that."[61]

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[57] Dan Froomkin, *Rubin: I Actually Supported Regulating Derivatives*, HUFFINGTON POST (June 20, 2010), http://huff.to/aMXj1N.
[58] *Id.*
[59] Testimony of former Federal Reserve Chairman Alan Greenspan before the House of Representatives Committee on Government Reform (110th Cong., Oct. 23, 2008), http://bit.ly/JcqBPL.
[60] *Id.*
[61] Dan Froomkin, *Rubin: I Actually Supported Regulating Derivatives*, HUFFINGTON POST (June 20, 2010) http://huff.to/aMXj1N.

D. Dodd-Frank Enacted Significant Reforms but Members of Congress Are Seeking to Reduce These Protections.

The Dodd-Frank law instituted measures to make derivatives trading transparent and less risky for the financial system. The law generally called for swaps to be traded on designated exchanges, to be cleared by designated organizations, and to be subject to capital and margin requirements.

Trading on exchanges provides for transparency, permitting buyers to shop for competitive prices. Clearing ensures that centralized organizations accept responsibility to make good on contract obligations. This would prevent reprisals of the AIG episode, in which no backstop was in place—save for the taxpayers. The capital and margin requirements plug the gaping regulatory hole that allowed the likes of AIG to take on risks that exceeded its resources. The act allowed swaps that are highly customized be traded off of exchanges. But even in these cases, it imposed capital and margin requirements and insisted on public reporting.[62]

Since the passage of Dodd-Frank, industry has engaged in a concerted effort to weaken it. At least nine bills are pending in Congress that would water down its derivatives reforms. Three additional bills would saddle federal agencies with additional burdens to fulfill requirements to issue concerning financial services, including those involving derivatives. [See Appendix]

Among other things, these bills would eliminate a requirement for federally insured banks to spin off their derivatives operations;[63] reduce disclosure requirements for certain derivatives trades;[64] provide a broad exemption from Dodd-Frank's provisions for swaps involving foreign affiliates of U.S. companies;[65] and exempt purportedly small players, even those with up to $200 billion in the notional value of their derivatives exposure.[66]

These proposals threaten to create large oversight-free zones that could allow risky behaviors to flourish. We have seen the damage caused by the errors in judgment in the late 1990s. Congress and federal agencies need to ensure that there is no sequel.

[62] Dodd-Frank Wall Street Reform and Consumer Protection Act § 701-814 and DERIVATIVES IN THE CRISIS, at 17-26.
[63] H.R. 1838, 112th Cong. (2011).
[64] H.R. 2586, 112th Cong. (2011).
[65] H.R. 3283, 112th Cong. (2011).
[66] H.R. 3336, 112th Cong. (2012) and Letter from Americans for Financial Reform to members of Congress (April 11, 2012).

Appendix

Bills Seeking to Weaken Derivatives Regulation

Bill Number, Title Sponsor	Brief Summary	Status
H.R. 1838, Swaps Bailout Prevention Act, Rep. Nan Hayworth (R-N.Y.)	Amends Section 716 of Dodd-Frank (known as the Lincoln amendment), which bans federally insured financial institutions from engaging in swaps trading. Amended in committee to exempt foreign swap activity by subsidiaries of U.S. banks.	Passed House Committee on Financial Services by voice vote, Feb 16, 2012.
H.R. 2586, Swap Executive Facility Clarification Act, Rep. Scott Garrett (R-N.J.)	Bans regulators from requiring swaps exchanges (SEFs) to make bids or offers available to participants.	Passed House Committee on Financial Services by voice vote, Nov. 30, 2011; Passed House Committee on Agriculture by voice vote, Jan. 25, 2012.
H.R. 2682, Business Risk Mitigation and Price Stabilization Act, Rep. Michael Grimm (R-N.Y.)	Prohibits regulators from requiring derivatives end users qualifying for clearing exemption (such as airlines) to post margin.	Passed House 370-24 on March 26, 2012. (Corresponds with Senate Bill S. 1650)
H.R. 2779, (no title), Rep. Steve Stivers (R-Ohio)	Provides broad exemption from regulation of swaps between affiliates.	Passed House 357-36, March 26, 2012.
H.R. 3283, Swap Jurisdiction Certainty Act, Rep. Jim Himes (D-Conn.)	Provides broad regulatory exemption for U.S. swap dealers when dealing with foreign entities, including foreign affiliates of U.S. companies; replaces U.S. capital regulation and oversight for foreign affiliates of U.S. companies with oversight by the non-U.S. jurisdiction.	Passed House Committee on Financial Services 41-18, March 27, 2012; referred to House Committee on Agriculture.
H.R. 3336, Small Business Credit Availability Act, Rep. Vicky Hartzler (R-Mo.)	Exempts any bank, thrift, credit union or farm credit institution from being considered a “financial entity” if it has less than $1 billion in “outward exposure” or swaps connected to hedges.	Passed House 312-111, April 25, 2012.
H.R. 3527, Protecting Main Street End-Users from Excessive Regulation, Rep.Randy Hultgren (R-Ill.)	Exempts transactions for hedging or mitigating commercial risk from the calculation of whether one meets the threshold to be designated as a swap dealer; creates exemption from margin and clearing requirements for swap dealers trading up to $3 billion in notional value annually.	Passed House Committee on Agriculture by voice vote, Jan. 25, 2012.
S. 947, (no title), Sen. Mike Johanns (R-Neb.)	Exempts various trades from specified margin requirements, including swaps in which one of the counterparties is neither a swap dealer nor a major swap participant.	Referred to Senate Committee on Banking, Housing, and Urban Affairs.
S. 1650, Dodd-Frank Improvement Act, Sen. Mike Crapo, (R-Idaho)	Establishes SEC Office of Derivatives to coordinate oversight and administer derivatives-related rules.	Referred to Senate Committee on Banking, Housing, and Urban Affairs.

Bills Imposing Addition Burdens for Agencies to Promulgate Financial Regulations

Bill Number, Title Sponsor	Brief Summary	Status
H.R. 1840, no title, Rep. Michael Conaway (R-Texas)	Requires detailed cost-benefit analysis of all CFTC regulations.	Passed by House Committee on Agriculture by voice vote, Jan. 25, 2012.
H.R. 2308, SEC Regulatory Accountability Act, Rep. Scott Garrett (R-N.J.)	Requires detailed cost-benefit analysis of all SEC regulations.	Approved by House Financial Services Committee 30-26, Feb. 16, 2012.
S. 1615, Financial Regulatory Responsibility Act of 2011, Sen. Richard Shelby (R-Ala.)	Prohibits issuance of regulations if quantified costs are greater than the quantified benefits; authorizes judicial review for a person adversely affected or aggrieved by a regulation; establishes the Chief Economists Council to report to certain congressional committees on activities of the financial regulatory agencies.	Referred to Senate Committee on Banking, Housing, and Urban Affairs.