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ABSTRACT

This Article critically examines the legal nature of credit default swaps. Functionally a form of credit default insurance, CDSs are however commonly characterized as largely unregulated financial derivatives, and were widely blamed for exacerbating the global financial crisis of 2007-09 and contributing to the European debt crisis starting in 2010. This Article demonstrates that the classification of CDSs as derivatives is due to a misapplication of insurance law principles and a glaring misreading of relevant legislation. Furthermore, CDSs are structurally and economically not swaps, which raises suspicions of deliberate evasion of the law by classifying them as swaps. Given the widespread confusion surrounding CDSs, this Article examines the history of the legal concept of swaps and demonstrates that the International Swaps and Derivatives Association developed them in order to exploit regulatory exemptions, which were later extended to an increasing range of deregulated transactions. Additionally, the Dodd-Frank Act reforms, which seek to control the excesses of financial innovation, paradoxically consolidate the regime of largely unregulated swaps. Ongoing legal and policy issues are highlighted.

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INTRODUCTION

Credit default swaps ("CDSs") have been subject to heated debates. The opacity of piled-up risks due to CDSs and securitization is seen as one cause of the banking crisis of 2007-09,[1] and CDS speculation is blamed for exacerbating the European sovereign debt crisis that started in 2010.[2] Apart from igniting regulatory debates, these crises revealed a legal problem: how should these contracts be legally classified and regulated?[3]

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1. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 8–10, 50–51, 140–46, 188–95, 200–02, 243–44, 348–51, 376–79 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter FCIC REPORT]. *But see id.* at 447 (dissenting statement).

2. *See, e.g.*, James Rickards, *How Markets Attacked the Greek Piñata*, FIN. TIMES (Feb. 11, 2010), http://www.ft.com/cms/s/0/e7168fc6-1740-11df-94f6-00144feab49a.html; Wolfgang Münchau, *Time to Outlaw Naked Credit Default Swaps*, FIN. TIMES (Feb. 28, 2010), http://www.ft.com/cms/s/0/7b56f5b2-24a3-11df-8be0-00144feab49a.html.

3. *See, e.g.*, Arthur Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. INS. L. J. 241 (2008) (arguing that CDSs are functionally similar to insurance); M. Todd Henderson, *Credit Derivatives Are Not "Insurance"*, 16 CONN. INS. L. J. 1 (2009) [hereinafter Henderson, *Credit Derivatives Are Not "Insurance"*] (disagreeing with Kimball-Stanley); Oskari Juurikkala, *Credit Default Swaps and Insurance: Against the Potts Opinion*, 26 J. INT'L BANKING L. & REG. 128 (2011) [hereinafter Juurikkala, Potts Opinion] (arguing that at least some CDSs may be insurance contracts).

In terms of legal categories, there are two fundamental views of CDSs. One is the *derivatives-based* understanding that CDSs are essentially options or swaps.[4] This view tends to be skeptical of regulation, highlighting the benefits of CDSs and the disadvantages of insurance law and favoring self-governance or, at most, central counterparty clearing of CDSs.[5] The opposing view is the *insurance-based* understanding of CDSs, which often coincides with arguments in favor of regulation.[6]

The current legal and regulatory environment is a puzzling mixture of both of these views. On the one hand, CDSs are commonly assumed to be largely unregulated derivatives, but the legal argument for this view is doubtful if not entirely mistaken.[7] On the other hand, post-crisis reforms, such as the Dodd-Frank Act,[8] mostly reflect the derivatives-based view, but at the same time, U.S. state legislators sought to regulate CDSs as insurance[9] while similar proposals were mooted at federal level.[10] Moreover, the new European sovereign CDS short-selling prohibition, adopted in 2012, "reflects an insurance-based understanding of credit default swaps."[11]

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4. For representative views, see Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167 (2007); Houman B. Shadab, *Guilty by Association? Regulating Credit Default Swaps*, 4 ENTREPRENEURIAL BUS. L. J. 407, 419–21 (2010); Henderson, *Credit Derivatives Are Not "Insurance"*, *supra* note 3.

5. *See* Henderson, *Credit Derivatives Are Not "Insurance," supra* note 3, at 22–46, 56–59; Shadab, *supra* note 4, at 435–41, 452–62.

6. *See* Benjamin B. Saunders, *Should Credit Default Swap Issuers Be Subject to Prudential Regulation?*, 10 J. OF CORP. L. STUD. 427 (2010) (advocating reserves regulation for CDSs sellers); Kimball-Stanley, *supra* note 3, at 248–49 (2008); Juurikkala, Potts Opinion, *supra* note 3 (finding flaws in the legal arguments for the derivatives-based understanding). This view has also been adopted by U.S. insurance regulators recently. *See infra* Part II.H.3–4. On reserves regulation, see, for example, PETER D. SPENCER, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS 68–69 (2000) (explaining the prudential regulation of insurance companies). On the insurable interest doctrine, see *infra* Part II.E.1.

7. *See infra* Part II.

8. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see infra* Part III.C.

9. *See infra* Part II.H.4.

10. *See infra* note 347 and accompanying text.

11. Oskari Juurikkala, *Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis*, 9 EUR. COMPANY & FIN. L. REV. 307, 309 (2012) [hereinafter Juurikkala, *EU Short Selling Regulation*]; *see also* Regulation on Short Selling and

Earlier studies have incompletely addressed the matter, but this Article provides the first in-depth analysis of the issues concerning the legal characterization of CDSs.[12] The Article is structured as follows. Part I presents an overview of CDSs, explaining their mechanics and uses, summarizing their benefits and risks, and discussing how the current legal environment has given rise to both uncertainty and major misunderstandings.

Part II investigates the relationship between insurance law and CDSs. It summarizes the consequences of insurance regulation, discusses the different ways of demarcating insurance law, and scrutinizes the arguments that CDSs are not insurance. In addition to correcting misinterpretations of insurance law, Part II also sheds light on the economic functioning of CDSs. Finally, this Part analyzes the evolution of the views of U.S. state insurance regulators on this matter.

Part III explores how CDSs came to be considered deregulated swap transactions. It traces the history and evolution of derivatives law and pays special attention to the legal and political influences of the International Swaps and Derivatives Association (ISDA), an industry organization of the derivatives business.[13] This Part demonstrates how ISDA skillfully obtained exemptions to the regulations and manipulated key concepts, such as swaps, in order to widen the space of unregulated activities. Finally, Part III critically examines the Dodd-Frank Act reforms, showing that they paradoxically consolidate ISDA's regime of deregulated derivatives.

Certain Aspects of Credit Default Swaps (EU) 236/2012, 2012 O.J. (L86/1) (Mar. 14, 2012).

12. The majority of legal papers on CDSs focus on the question of whether CDSs *should* be regulated as insurance or otherwise, addressing the classification problem in current law only cursorily. *See, e.g.*, Kimball-Stanley, *supra* note 3; Saunders, *supra* note 6 (both favoring insurance regulation); Henderson, *Credit Derivatives Are Not "Insurance," supra* note 3; Schwartz, *supra* note 4 (both opposing insurance regulation). The specific legal question is addressed in Juurikkala, Potts Opinion, *supra* note 3, but only with respect to the Potts opinion. Earlier studies have also included significant errors, for example, regarding the interpretation of New York Insurance Law. *See infra* notes 64–68 and accompanying text.

13. *See* Joanne P. Braithwaite, *Standard Form Contracts as Transnational Law: Evidence From the Derivatives Markets*, 75 MODERN L. REV. 779 (2012) (describing ISDA's contract architecture).

I. CREDIT DEFAULT SWAPS: AN OVERVIEW

A. DESCRIPTION

The history of CDSs extends to the early 1990s, as J.P. Morgan bankers invented the first credit derivatives in 1994.[14] The CDS market peaked in 2007 at $57.8 trillion in notional value.[15]

CDSs might seem complicated, but their basic structure is straightforward. A CDS is a contract between two parties, whereby one party (the "protection buyer") pays periodic fees in return for a promise by the other (the "protection seller") to compensate for the loss of value of the reference obligation(s) in case of a credit event.[16] The concept of "credit event" is defined broadly to include events other than outright nonpayment, and the parties can negotiate such events.[17]

Economically, CDSs resemble such contracts as credit insurance and guaranties.[18] In one sense, because CDSs are two-party relationships, they are more like insurance than guaranties, which necessarily involve three parties.[19] Yet, if and insofar as CDSs can legally be bought and sold without being exposed to the credit risk, they

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14. *See* Gillian Tett, *The Dream Machine: Invention of Credit Derivatives*, FIN. TIMES, Mar. 24, 2006, *available at* http://www.ft.com/cms/s/0/7886e2a8-b967-11da-9d02-0000779e2340.html (tracking the invention and development of credit derivatives).

15. *See, e.g.*, Shadab, *supra* note 4, at 432–33. However, market size is an estimate and subject to dispute regarding measurement methodology. *See id.*

16. *See, e.g.*, ERIK BANKS, MORTON GLANTZ & PAUL SIEGEL, CREDIT DERIVATIVES: TECHNIQUES TO MANAGE CREDIT RISK FOR FINANCIAL PROFESSIONALS 7 (2007) ("In a basic CDS the credit protection buyer pays the credit protection seller an up-front or periodic fee in exchange for a compensatory payment that becomes due and payable if the reference credit defaults during the life of the contract."); *see also* EDMUND PARKER, CREDIT DERIVATIVES: DOCUMENTING AND UNDERSTANDING CREDIT DERIVATIVE PRODUCTS 27–30 (2007).

17. Anna Gelpern & Mitu Gulati, *CDS Zombies*, 13 EUR. BUS. ORG. L. REV. 347, 361–62 (2012); PARKER, *supra* note 16, at 28.

18. David Rule, *The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability*, FIN. STABILITY REV. 117, 118 (2001), *available at* http://mng.ibu.edu.ba/assets/userfiles/mng/feb2013/Reading%20Credit%20derivative%20markets.pdf.

19. *See* Robert D. Aicher, Deborah L. Cotton & T.K. Khan, *Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)*, 59 BUS. LAW. 897, 921 (2004) (comparing guaranties and insurance).

differ from insurance and become a form of betting on debtors' default.[20]

The CDS market is over-the-counter ("OTC"), meaning that CDS contracts are bilaterally negotiated and not publicly traded.[21] However, most CDSs adopt the standardized Master Agreements of ISDA.[22] In the case of default, settlement may take place either physically (by accepting delivery of the underlying assets and paying par value) or in cash (paying the difference between par value and market value after default).[23]

B. REGULATORY ASSESSMENT

1. Benefits

Generally, the key benefits of CDSs derive from an improved flexibility for managing certain risks and obtaining efficiency-enhancing investment positions.[24] They are more flexible than traditional guaranties or credit insurance because they are more easily customized to suit particular risk profiles.[25]

There are also indirect benefits due to the positive externalities of the CDS market. Given that the CDS market has become more liquid and standardized, it has become easier to compare offers, and their

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20. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2007) ("[A] credit default swap is a private contract in which private parties bet on a debt issuer's bankruptcy.").

21. For more on OTC derivatives, see, for example, Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677 (2002); ALFRED STEINHERR, DERIVATIVES: THE WILD BEAST OF FINANCE 151–68 (2000).

22. Precise data is hard to find, but Braithwaite provides a range of evidence suggesting that "an estimated 90 per cent of all OTC derivatives are governed by the standardised documentation" of ISDA. *See* Braithwaite, *supra* note 13, at 784. Regarding CDSs specifically, Gelpern & Gulati argue that "[i]t is hard to conceive of a stronger and more successful trade group in charge of more important contracts than ISDA, if success is to be measured by share of the contract market and importance by dollar volume". Gelpern & Gulati, *supra* note 17, at 355–56.

23. BANKS, GLANTZ & SIEGEL, *supra* note 16, at 33; *see also* Feder, *supra* note 21, at 708–09 (describing cash-settlement and physical settlement in OTC derivatives).

24. STEINHERR, *supra* note 21, at 166–67.

25. Rule, *supra* note 18, at 118.

pricing has probably become more efficient.[26] Moreover, as CDS prices have begun to be publicly quoted, they have become a source of timely information on the market's estimates on default probabilities.[27]

2. Risks and Concerns

However, CDSs have some shortcomings. First, they involve *firm-level* risks, as CDSs may be transacted without fully understanding and controlling the risks.[28] For example, selling CDS protection is functionally equivalent to selling insurance, which is a highly risky industry, and firms might not have a sufficient understanding or adequate control procedures.[29]

Second, CDSs appear to *negatively influence incentives*. On the one hand, they can harm borrower-lender relationships by reducing screening and monitoring incentives.[30] On the other hand, it is feared that CDSs misalign incentives in the event of default.[31] CDS value is determined by credit events so that bondholders possessing CDS protection may benefit from pushing distressed debtors into bankruptcy (this is called the *empty creditor problem*).[32] This can be socially costly

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26. The lack of price transparency in OTC derivatives markets tends to mean that dealers exploit less well-informed end users. *See* STEINHERR, *supra* note 21, at 157 (citing evidence that "OTC issuers may charge up to 45% over the theoretical option price").

27. *See* Mark J. Flannery, Joel F. Houston & Frank Partnoy, *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085 (2010) (proposing CDS spreads as a substitute for credit ratings).

28. Agasha Mugasha, *The Secondary Market for Syndicated Loans: Loan Trading, Credit Derivatives, and Collateralized Debt Obligations*, 19 BANKING & FIN. L. REV. 199, 220 (2004) [hereinafter Mugasha, *Syndicated Loans*].

29. *See id.* at 221–23.

30. *See* Rym Ayadi & Patrick Behr, *On the Necessity to Regulate Derivatives Markets*, 10 J. BANKING REG. 179, 187–89 (describing incentive issues associated with credit derivatives).

31. David McIlroy, *The Regulatory Issues Raised by Credit Default Swaps*, 11 J. BANKING REG. 303, 307–09 (2010) (discussing incentive issues of CDSs in the case of default).

32. *See generally* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) (developing the theory of "empty voting" and "hidden (morphable) ownership"); Patrick Bolton & Martin Oehmke, *Credit Default Swaps and the Empty Creditor Problem*, 24 REV. FIN. STUD. 2617 (2011) (demonstrating formally that credit default

given the wider social and economic ramifications of corporate restructuring and bankruptcy.

Third, one motivation for CDSs is *regulatory arbitrage*, as they give "access to credit markets which are otherwise restricted by corporate statute or off-limits by regulation."[33] There is evidence that much of the CDS market is connected to regulatory arbitrage.[34] This is problematic when those restrictions are reasonable. CDSs have enabled financial institutions to take on more risks that are highly opaque to both investors and regulators, so instead of improving the pricing of credit risks, CDSs made it more difficult to correctly locate and price risks.[35] Moreover, CDSs can be used for insider trading.[36]

Fourth, credit default swaps may give rise to *negative externalities*, as spreading credit risk more widely has increased systemic risks.[37] In other words, credit risk transfer may improve risk management in individual cases but has exacerbated system-wide instability because difficulties in one sector extend to the entire market.[38] The opacity of the CDS market has also made it possible for huge amounts of risk to be concentrated without the notice of other market participants or regulators.[39] Before the crisis that started in 2007, many commentators downplayed the issue,[40] but subsequent events—particularly the AIG fiasco—have proven otherwise.[41]

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insurance reduces the incidence of strategic default, but causes an inefficiently high incidence of costly bankruptcy).

33. André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the Unites States and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 151 (2000). On the notion of regulatory arbitrage, see Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997) [hereinafter Partnoy, *Regulatory Arbitrage*].

34. *See* Ayadi & Behr, *supra* note 30, at 186 (describing the principal motivations for using credit derivatives).

35. *See* McIlroy, *supra* note 31, at 305–07 (discussing the opacity and complexity created by CDSs).

36. *See generally* Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives* 84 J. FIN. ECON. 110 (2007); *see also* Juurikkala, *EU Short Selling Regulation*, *supra* note 11, at 313–15 (describing regulatory reactions).

37. For a detailed study on the notion of systemic risk in financial markets, see Steven L. Schwarcz, *Systemic Risk*, 97 GEORGETOWN L. J. 193, 200 (2008).

38. *See* Ayadi & Behr, *supra* note 30, at 189–91.

39. *See* McIlroy, *supra* note 31, at 309; Shadab, *supra* note 4, at 444–52 (discussing overconcentration of CDS exposure).

40. *See, e.g.*, Tim Weithers, *Credit Derivatives, Macro Risks, and Systemic Risks*, FED. RES. BANK ATLANTA ECON. REV. 43 (2007), *available at*

Fifth, unrestricted opportunities for betting on debtors' default can destabilize distressed markets.[42] In theory, these opportunities might improve market efficiency, but in practice, there is little empirical support for this, and many borrowers have suffered from CDS speculation.[43] In informationally imperfect markets, CDSs may also be used to generate destabilizing signals, and regulators have been concerned about market manipulation.[44]

C. LEGAL ALTERNATIVES, UNCERTAINTY, AND MYTHS

Before a detailed analysis of CDSs as either insurance or derivatives, it is necessary to place the issues in a bigger picture. Before the Dodd-Frank Act, the legal characterization of CDSs was open to debate, and practically no case law clarified the matter.[45] In two U.S. cases, the courts pronounced *obiter dicta* on the nature of CDSs, one

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http://www.frbatlanta.org/filelegacydocs/erq407_weithers.pdf (discussing systemic risk and arguing that risk dispersion has reduced systemic risk in banking, although admitting that risk concentration in hedge funds could be a problem).

41. On the AIG case, see William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009), http://law.wlu.edu/deptimages/Law%20Review/66-3Sjostrom.pdf; FCIC REPORT, *supra* note 1, at 50, 139–42, 200–02, 243–44, 265–74, 344–52; Shadab, *supra* note 4, at 447–52.

42. *See* Juurikkala, *EU Short Selling Regulation*, *supra* note 11, at 325–28 (discussing empirical evidence).

43. *Id.* at 325–26; *see also* Adam B. Ashcraft & João A.C. Santos, *Has the CDS Market Lowered the Cost of Corporate Debt?* 56 J. MONETARY ECON. 514 (2009) (finding insignificant benefits overall, and major adverse effects on risky and informationally opaque borrowers).

44. Juurikkala, *EU Short Selling Regulation*, *supra* note 11, at 328; *see also Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions Before S. Comm. on Banking, Housing, & Urban Affairs*, 110th Cong. 1 (2008) (statement of Christopher Cox, Chairman of the SEC), *available at* http://www.sec.gov/news/testimony/
2008/ts092308cc.htm (explaining an enforcement investigation and referring to "the significant opportunities that exist for manipulation in the $58 trillion CDS market, which is completely lacking in transparency and completely unregulated").

45. *See* Schwartz, *supra* note 4, at 173 (citing data on the scarcity of CDS litigation); Aicher, Cotton & Khan, *supra* note 19, at 956 (noting the lack of decided CDS cases).

likening them to insurance[46] and the other differentiating them,[47] but neither decision ruled on the classification issue.[48]

The Potts opinion of 1997 supports the derivatives-based view, arguing that CDSs were not insurance in English law.[49] That view is carefully examined later,[50] but even supposing it to be correct *in arguendo*, the opinion does not explain what CDSs are. As explained in this section, the matter continues to remain open in many respects.

1. CDSs as Securities: Early Opinions and Contrary Legislation

According to one U.S. attorney, "[u]ntil December 2000, the prevailing opinion among practitioners was that CDSs were securities under the Securities Act" because "a CDS was viewed as a put on an evidence of indebtedness."[51] That view is doubtful, because economically, a CDS is definitely not a put on an evidence of

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46. *See* Merrill Lynch Int'l v. XL Capital Assurance et al., 564 F. Supp. 2d 298, 300 (S.D.N.Y. 2008) ("A credit default swap is an arrangement similar to an insurance contract. The buyer of protection . . . pays a periodic fee, like an insurance premium, to the seller of protection . . . , in exchange for compensation in the event that the insured security experiences default.").

47. *See* AON Fin. Prods., Inc. v. Societe Generale, 476 F.3d 90, 96 (2d Cir. 2007) ("CDS agreements are thus significantly different from insurance contracts."). Interestingly, the court cited an ISDA *amicus curiae* brief stating that CDSs "do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation." *Id*. However, this generic description evades the question of how CDSs are structured and does not differentiate them from insurance. In fact, the court's own definition of CDSs was plainer: "[c]redit default swaps are a method by which one party (the protection buyer) transfers risk to another party (the protection seller)." *Id*.

48. Like most CDS cases, these two cases were concerned with whether a credit event had occurred within the meaning of the terms of the contract. *See id.; see also Merrill Lynch Int'l*, 564 F. Supp. 2d at 298.

49. *See* ROBIN POTTS, CREDIT DERIVATIVES: OPINION (1997) (on file with author) [hereinafter POTTS OPINION]; *see, e.g.*, Kimball-Stanley, *supra* note 3, at 246–47.

50. *Infra* Part II.C.

51. Sjostrom, *supra* note 41, at 984; *see also* Adam W. Glass, *CFMA Brings Legal Certainty, but Additional Liability for Credit Derivatives: Part One*, LINKLATERS, 1 (2001), *available at* http://www.linklaters.com/pdfs/publications/us/cfmaapril2001.pdf.

indebtedness.[52] Moreover, many CDSs were probably transacted as unregulated swaps rather than securities.[53]

In 2000 the Commodity Futures Modernization Act ("CFMA"),[54] the first piece of U.S. legislation explicitly addressing CDSs, removed the potential of characterizing CDSs as securities by determining that swap agreements, including CDSs, are *not* securities under the federal securities laws.[55] The act also excluded the regulation of CDSs as commodity derivatives, treating them as exempted swap transactions.[56] However, CFMA did not exclude the application of insurance laws to transactions that resemble insurance.[57]

2. Letter of Credit, Guaranty, or Financial Guaranty Insurance?

Another view, advanced in light of English law, is that CDSs are analogous to a letter of credit or a third-party guarantee.[58] However, even if some similarities exist, the classification is inaccurate because letters of credit and third-party guarantees are fundamentally *three-party* relationships whereas CDSs are structured as *two-party* relationships

52. Evidence of indebtedness could influence CDS prices, but payments under CDSs are determined by specific credit events.

53. There is no hard data on the early development of the market for CDSs, and moreover, "[t]here is substantial uncertainty surrounding the definition of 'security.'" Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT'L ECON. L. 421, 495 n.26 (2001) [hereinafter Partnoy, *Derivatives Regulation*].

54. Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified in scattered sections of 7, 11, 12, and 15 U.S.C.); *see also infra* Part III.B.5.

55. *See* Sjostrom, *supra* note 41, at 984–85; *see also* Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3099 (2008).

56. *See* Sjostrom, *supra* note 41, at 986; *see also* Wynkoop, *supra* note 55, at 3100.

57. *See Hearing to Review the Role of Credit Derivatives in the US Economy: Testimony to the H. Comm. On Agric.* 110th Cong. 4 (2008), *available at* http://www.dfs.ny.gov/about/speeches_ins/sp0811201.pdf (testimony of Eric Dinallo, N.Y. Superintendent of Ins.) (explaining the effects of CFMA and highlighting that the insurance issue was left open); *see also* Schwartz, *supra* note 4, at 173 (noting that "the state of insurance regulation remains unsettled in many places").

58. *See* Schuyler K. Henderson, *Regulation of Credit Derivatives: To What Effect and for Whose Benefit? Part 6*, 8 J. INT'L BANKING & FIN. L. 480, 481–82 (2009) [hereinafter Henderson, *Regulation of Credit Derivatives*].

whereby payment depends on external and flexibly negotiable credit events.[59]

According to one representative of U.S. insurance legislators, CDSs are really a form of financial guaranty insurance.[60] The evolving attitude of insurance regulators is examined later, but it should be noted that financial guaranty insurance is a novel and peculiar form of insurance that is normally tripartite, like a letter of credit written by an insurer.[61] Therefore, it seems inaccurate to treat all CDSs as financial guaranty insurance, although statutory definitions of financial guaranty insurance are broad,[62] so some CDSs might be caught.

3. New York Insurance Law: The Misquoted Article 69

While there is uncertainty, there are also myths. One of them is the common, but erroneous, belief that the possibility of classifying CDSs as insurance was excluded in New York State in 2004, when Article 69 of the New York Insurance Law (dealing with financial guaranty insurance) was amended to define some aspects of CDSs.[63] Several commentators claimed that the amendment definitively excluded CDSs from insurance regulation, citing § 6901(j-1): "the making of [a] credit default swap does not constitute the doing of an insurance business."[64] Thus, Shadab writes that New York "in 2004 codified that position [that CDSs do not qualify as insurance contracts] in Article 69 of the New

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59. *See supra* notes 17–19 and accompanying text; *see also* Aicher, Cotton & Khan, *supra* note 19, at 899–900 (describing letters of credit), 910–11 (guaranties), 954–56 (CDSs). Letter of credit and guaranties differ in that the first is subject to the "independence principle" whereas the latter are strictly secondary obligations. *Id.* at 902. There is long-standing confusion regarding the legal differentiation of different forms of credit enhancement. *Id.* at 898–99. The strictly two-party nature of CDSs is implicitly acknowledged by Henderson, *Regulation of Credit Derivatives*, *supra* note 58, at 482 ("It is a fundamental cornerstone of the CDS market that performance is based on its contractual terms, objectively applied . . . .").

60. *See Hearing to Review Derivatives Legislation Before the H. Comm. On Agric.*, 111th Cong. 147–48 (2009), *available at* http://agriculture.house.gov/sites/republicans.agriculture.house.gov/files/testimony/111/111-1.pdf (statement of the Hon. Joseph D. Morelle, N.Y. Assemb. And Chairman, Standing Comm. on Ins., testifying on behalf of the Nat'l Conference of Ins. Legislators).

61. *See* Aicher, Cotton & Khan, *supra* note 19, at 930–32.

62. *See id.* at 934–35.

63. N.Y. INS. LAW § 6901 (McKinney 2014).

64. *See, e.g.*, Kimball-Stanley, *supra* note 3, at 252 (citing exactly this).

York Insurance Law."[65] Schwartz states that "New York updated its insurance laws to exclude CDS in 2004"[66] and that this "permanently quelled the worries of those who feared insurance treatment for CDS."[67] Kimball-Stanley comments: "The statute is hardly a convincing analysis of the legal issues involved in such a statement; but it is effective nonetheless."[68]

However, this is all a misunderstanding because the statutory sentence has been taken out of context. The original paragraph defines the meaning of CDSs for the purposes of New York Insurance Law and *adds a caveat* to highlight that the definition only applies *on the condition* that the agreement is not deemed to be an insurance contract.

> "Credit default swap" means an agreement referencing the credit derivative definitions published from time to time by the International Swap and Derivatives Association, Inc. or otherwise acceptable to the superintendent, pursuant to which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event in respect of, an issuer of a specified security or other obligation; *provided that* such agreement does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business.[69]

The original purpose of the last sentence is *to warn that the application of insurance law to CDSs had not been settled*. Insurance Superintendent Eric R. Dinallo emphasized this interpretation and clarified the meaning of the paragraph in September 2008: "[t]hus, provided that the making of the CDS itself 'does not constitute the doing of an insurance business,' Insurance Law . . . permits FGIs [financial

65. Shadab, *supra* note 4, at 429.

66. Schwartz, *supra* note 4, at 173; *see also* Sjostrom, *supra* note 41, at 988 (asserting that "[t]his [that CDSs have not been subject to insurance regulations] was made crystal clear by the state of New York in 2004 when it amended its insurance laws specifically to exclude CDSs from coverage.)"

67. Schwartz, *supra* note 4, at 183; *see also* Charles K. Whitehead, *Reframing Financial Regulation*, 90 B. U. L. REV. 1, 34 (2010) ("In New York . . . most of AIGFP's [credit default] swaps were expressly excluded from insurance regulation.").

68. Kimball-Stanley, *supra* note 3, at 252.

69. N.Y. INS. LAW § 6901(j-1) (McKinney 2014) (emphasis added).

guaranty insurance companies] to issue insurance policies that guarantee payments by transformers or other parties pursuant to such a CDS."[70]

In other words, Article 69 states that insurers could sell financial guaranty insurance to guarantee *non-insurance CDSs*, implying that some CDSs could be insurance and their differentiation must be determined independently.

4. Recent Reforms and the Ongoing Relevance of the Insurance Question

In the U.S., the Dodd-Frank Act somewhat clarified the legal status of CDSs by excluding their characterization as insurance and imposing mandatory clearing for most CDSs.[71] However, the solution is puzzling, as it depends on a paradoxical concept of "swap" that departs from financial definitions, which may cover many insurance contracts.[72] The insurance question has ongoing policy relevance because Dodd-Frank fails to address many regulatory concerns and raises new ones.[73]

The insurance issue is, thus, more immediately relevant in Europe, including the UK due to its dominant market in credit derivatives.[74] In Europe, the common assumption that CDSs are derivatives has no clear legal foundation. For example, the new regulation imposing mandatory clearing for many OTC derivatives (commonly known as the European Market Infrastructure Regulation or "EMIR")[75] is commonly assumed to cover CDSs, but in fact, it makes no explicit reference to CDSs.

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70. Circular Letter No. 19, Re: "Best Practices" for Financial Guaranty Insurers from Eric R. Dinallo, Superintendent of the N.Y. Ins. Dep't, to all authorized financial guaranty insurers (Sept. 22, 2008), *available at* http://www.dfs.ny.gov/insurance/circltr/2008/cl08_19.htm; *see also* Sherri Venokur, Matthew Magidson & Adam M. Singer, *Comparing Credit Default Swaps to Insurance Contracts: Did the New York State Insurance Department Get It Right?*, 28 No. 11 FUTURES & DERIVATIVES L. REPORT 1, 4 (2008) ("[I]f the CDS itself does not constitute an insurance contract or the doing of an insurance business, then an FGI is permitted to issue an insurance policy that guarantees payments by a transformer or other party pursuant to such CDS.").

71. *See infra* Part III.C for a detailed discussion.

72. *See infra* notes 384–78 and accompanying text.

73. *See infra* Part III.C.2.

74. PARKER, *supra* note 16, at 13.

75. Regulation 648/2012 of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L 201) 1 (July 4, 2012).

Instead, it defines "derivative" or "derivative contract" by referring back to a list of instruments attached to the MiFID Directive.[76] This list does not mention CDSs either, only generically referring to "[d]erivative instruments for the transfer of credit risk."[77] If this is the legal basis for arguing that CDSs are not insurance, it is utterly inadequate because invoking it as a statutory classification would therefore be circular. Thus, the non-specific expression in MiFID does not provide demarcation criteria but simply presupposes the prior legal classification as a derivative.

II. CREDIT DEFAULT SWAPS AS INSURANCE CONTRACTS

Many specialists acknowledge that CDSs seem like insurance.[78] This Part outlines the implications of insurance regulation and concludes that CDSs are legally insurance because CDSs fall within standard definitions and tests and contrary arguments seem to be based on misunderstandings of insurance law. The development of the thinking of U.S. insurance regulators is also analyzed.

A. THE CONSEQUENCES OF INSURANCE REGULATION

Insurance regulation carries major practical significance. First, selling insurance without a proper license may render protection sellers civilly and criminally liable.[79] The rules vary between jurisdictions, but generally, "if credit default swaps are deemed insurance by an insurance regulator, a protection seller could be subject to criminal prosecution, substantial fines, and forfeiture of its corporate charter unless it

76. *Id*. at Art. 2(5).

77. Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments, 2004 O.J. (L145) 1, Annex 1, Section C(8) (Apr. 21, 2004).

78. *See, e.g.*, MARK J.P. ANSON, CREDIT DERIVATIVES 44 (1999) ("This type of swap may be properly classified as credit insurance."); FRANK SKINNER, PRICING AND HEDGING INTEREST AND CREDIT RISK SENSITIVE INSTRUMENTS 280 (2005) ("Credit default swaps . . . are actually default insurance.").

79. David Z. Nirenberg & Richard J. Hoffman, *Are Credit Default Swaps Insurance?*, 3 DERIVATIVES REP. 7, 8 (2001).

maintained the requisite licenses."[80] The protection buyer may also be able to recover the money paid or any loss sustained.[81]

Second, authorization to sell insurance implies a range of *regulatory burdens*, including loss reserves, capitalization, compulsory disclosures, and investment restrictions.[82] Therefore, firms may wish to avoid the application of insurance law.[83] Third, insurance law in most jurisdictions limits the freedom of protection buyers by imposing, the requirement of *insurable interest*, which limits speculative risk-taking.[84] Fourth, insurance contracts are normally subject to the principle of *utmost good faith*, which requires both parties to disclose all information that would influence the judgment of a prudent insurer.[85] The application of this principle varies greatly among jurisdictions and types of insurance.[86] In the U.S. in particular, there is "a substantial consumer protection element of the law governing insurance."[87]

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80. *Id.*; *see, e.g.*, N.Y. INS. LAW § 1101(a)(2) (McKinney 2014). In the U.K., the regime under the Financial Services and Markets Act 2000 is complicated because a person may be *authorized* by the Financial Services Authority (FSA), but if the *permission* does not extend to insurance, the breach is only subject to FSA sanctions, including criminal penalties. *See* JOANNA BENJAMIN, FINANCIAL LAW ¶¶ 10.17–10.20 (2007).

81. *See* MALCOLM CLARKE, POLICIES AND PERCEPTIONS OF INSURANCE LAW IN THE TWENTY-FIRST CENTURY 60 (2007) (describing U.K. rules); BENJAMIN, *supra* note 80, at 10.18.

82. *See, e.g.*, CLARKE, *supra* note 81, at 61–65 (describing a range of duties falling upon insurers in the UK); ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 112–23 (3rd ed. 2001) (describing statutory controls in the U.S.). Taxation and accounting rules are also specific to insurance. *See, e.g.*, HM REVENUE & CUSTOMS, GENERAL INSURANCE MANUAL (2011), *available at* http://www.hmrc.gov.uk/manuals/gimanual.

83. *See* Jan Hellner, *The Scope of Insurance Regulation: What Is Insurance for Purposes of Regulation?*, 12 AM. J. COMP. L. 494, 494 (1963).

84. *See infra* Part II.E.

85. *See* CLARKE, *supra* note 81, at 98–116 (discussing this principle critically).

86. *Id.*

87. Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 431–32 (2005).

B. DEMARCATING INSURANCE

1. Legal Definitions

Definitions cannot definitively demarcate the scope of insurance law, but are necessary as a matter of first impression. Although there is some variation among the conventional legal definitions of insurance, it is argued in what follows that the definitions agree on the fundamentals, and those fundamental elements embrace all or many CDSs.[88]

In the U.S., *Black's Law Dictionary* defines insurance as a "contract by which one party (the *insurer*) undertakes to indemnify another party (the *insured*) against risk of loss, damage, or liability arising from the occurrence of some specified contingency."[89] In the U.K., some statutes deal with insurance law, but the demarcation of insurance continues to be determined by common law and the regulators' interpretation thereof.[90] In the landmark case of *Prudential Insurance Co. v. Commissioners of Inland Revenue*, Judge Channell describes insurance:

> A contract of insurance, then, must be a contract for the payment of a sum of money, or for some corresponding benefit such as the rebuilding of a house or the repairing of a ship, to become due on the happening of an event, which event must have some [degree] of uncertainty about it and must be of a character more or less adverse to the interest of the person effecting the insurance.[91]

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88. This discussion is limited to U.S. and English law because they are the leading jurisdictions for CDS markets. The demarcation of insurance law does not appear fundamentally different in other jurisdictions although there are important differences in the details of insurance regulation.

89. BLACK'S LAW DICTIONARY 870 (9th ed. 2009). New York Insurance Law provides a longer but essentially similar definition. N.Y. INS. LAW § 1101(a) (McKinney 2014).

90. *See* FIN. SERVS. AUTH., FSA HANDBOOK: PERIMETER GUIDANCE MANUAL (PERG) ¶¶ 6.3.2, 6.5.2 (2012), *available at* http://media.fsahandbook.info/pdf/PERG.pdf [hereinafter FSA, PERG]; CLARKE, *supra* note 81, at 349.

91. *Prudential Ins. Co. v IRC*, [1904] 2 KB 658, 663. According to the FSA, *Prudential* is the best statement of the common law. FSA, PERG, *supra* note 90, ¶ 6.5.1.

There are three fundamental elements of insurance contracts: *payment*, *uncertainty*, and *adverseness* (*interest*).[92] It is evident that the broad definitions would include CDSs, at least in some cases, as many commentators acknowledge that a "CDS certainly appears to fall within this definition [in *Black's Law Dictionary*]."[93] Even Schwartz, who is critical of insurance law, concludes that "on their face, these [New York] statutes define insurance contracts such that CDS[s]—at least those with exogenous credit events—could be subject to insurance regulation."[94] Attempts to downplay the issue refer to non-legal definitions of insurance, such as those highlighting *risk pooling*,[95] which is important for insurance economics but not a legal criterion for demarcating insurance law, so these arguments lack legal merit.

2. Borderline Cases

Definitions are not the final word, though. Demarcations must be determined by courts and regulators, which are skeptical of generic definitions "because definitions tend sometimes to obscure and occasionally to exclude that which ought to be included."[96] Even statutes that provide a definition should not be blindly relied upon, as "the approach through formal definition leads to innumerable difficulties and, if taken seriously, unfortunate results."[97]

There is no simple way to determine borderline cases.[98] Courts at common law have developed a range of criteria based on the

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92. THE LAW COMMISSION & THE SCOTTISH LAW COMMISSIONS, INSURABLE INTEREST, 2008, Issue Paper 4, ¶ 7.19 [hereinafter LAW COMMISSIONS, INSURABLE INTEREST], *available at* http://www.scotlawcom.gov.uk/download_file/view/203/107. For similar definitions, see, for example, E.R. HARDY IVAMY, GENERAL PRINCIPLES OF INSURANCE LAW 3–4 (6th ed. 1993); NICHOLAS LEIGH-JONES, JOHN BIRDS & DAVID OWEN, MACGILLIVRAY ON INSURANCE LAW ¶ 1-1 (10th ed. 2003).

93. *See* Sjostrom, *supra* note 41, at 987.

94. Schwartz, *supra* note 4, at 181.

95. *See* Henderson, *Credit Derivatives Are Not "Insurance," supra* note 3, at 16.

96. *Department of Trade and Industry v St. Christopher Motorists Association* (1974) 1 All ER 395, at 396–97; *see also* CLARKE, *supra* note 81, at 347–52 (discussing the limits of definitions).

97. Hellner, *supra* note 83, at 495.

98. *Id*. at 500–04 (discussing various tests and their limits).

peculiarities of new cases.[99] However, the criteria seem to add little to the present discussion, as many of them are trivial and easily fulfilled in CDSs.[100] Only two criteria raise questions for CDSs. One, that "the insured event must be one that is adverse to the policyholder,"[101] is only relevant for some (so-called uncovered or "naked") CDSs.[102]

Another potentially relevant criterion is the "*major* or *primary purpose test*" developed in some U.S. cases, according to which, "where the major purpose of a contract is other than to indemnify the promise, there is no insurance."[103] However, the validity of this test is doubtful, as it is contradicted by some cases and "cannot prevail as a general test."[104] U.K. regulators expressly abolished the test: "The contract must be characterised as a whole and not according to its 'dominant purpose' or the relative weight of its 'insurance content'."[105] In any case, this test might not matter for CDSs because the *only* purpose of CDSs is precisely to indemnify, *e.g.*, to recover the loss of reference asset value due to default or another credit event.[106]

Some argue that "attempts at *evasion* of insurance regulation should not be tolerated," giving rise to a kind of positive presumption in favor of regulation.[107] This is relevant to CDSs because the very language of "swaps" may be interpreted as a camouflage.[108]

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99. *See, e.g.*, CLARKE, *supra* note 81, at 350 (describing features highlighted by English courts); Hellner, *supra* note 83, 500–12 (discussing U.S. cases).

100. For example, CLARKE, *supra* note 81, at 350, lists the following criteria: the provision of insurance must be a business of a certain degree of regularity (even if insurance is just one part of its business); the insurer's promise to pay must be "in money or in kind"; "the alleged insurer must be legally (*e.g.*, contractually) bound to pay the money or provide the benefit in kind . . . and the beneficiary must have a legally enforceable right to receive it"; and "the benefit is due only if a specified insured event occurs. Moreover, at the time of contracting, it must be uncertain whether the specified event will occur."

101. *Id.*

102. *See infra* Part II.E.2.

103. Hellner, *supra* note 83, at 502.

104. *Id.*

105. FSA, PERG, *supra* note 90, ¶ 6.5.4(3) (citing *Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd* [1997] Ch. 173 (C.A.)); *see also id.* ¶ 6.6.7.(2).

106. This will be discussed later in detail. *See infra* Part II.F.1. The point of the major purpose test is not to scrutinize the *motivations* of the insured party (which in CDS transactions may be speculative), but to distinguish contracts which have only a marginal *insurance element*. *See* Hellner, *supra* note 83, at 502–03.

107. *See* Hellner, *supra* note 83, at 503–04 (discussing this argument).

108. *See infra* Part II.D.3.

3. UK Financial Services Authority Guidelines

In the U.K., the difficulty of delineating the boundaries of insurance law has prompted the Financial Services Authority ("FSA")—which supervised both securities and insurance industries—to provide further guidance.[109] This guidance is not conclusive and does not explicitly discuss CDSs, but it corroborates the impression that English insurance law covers CDSs.

First, the FSA lists transactions that are *unlikely* to be regarded as insurance. These include contracts that appear to be "pre-payment for services to be rendered in response to a future contingency";[110] contracts of "periodic maintenance of goods or facilities";[111] and contracts under which "the provider stands ready to provide services on the occurrence of a future contingency, on condition that the services actually provided are paid for by the recipient at a commercial rate."[112] CDSs resemble none of these transactions.

Second, in terms of affirmative criteria, the FSA highlights the "assumption of risk" by the insurer as "an important descriptive feature of all contracts of insurance."[113] For the FSA, the assumption of risk has the same meaning as the "transfer of risk."[114] This is precisely the fundamental element of CDSs. It does not matter if the provider "trades without any risk,"[115] as may be the case with an investment bank acting as a CDS intermediary.

With respect to borderline cases, the FSA notes that insurance law is more likely to apply "if the amount payable by the recipient under the contract is calculated by reference to either or both of the probability of occurrence or likely severity of the uncertain event."[116] This is the case for CDSs, at least in practice, because CDS premiums or spreads reflect

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109. FINANCIAL SERVICES AUTHORITY, THE IDENTIFICATION OF CONTRACTS OF INSURANCE (2004) [hereinafter FSA, INSURANCE], *available at* http://www.fsa.gov.uk/pubs/policy/ps04_19.pdf; this document updated the guidance in FSA, PERG, *supra* note 90, at Chapter 6.

110. FSA, PERG, *supra* note 90, ¶ 6.6.3.

111. *Id.* ¶ 6.6.4.

112. *Id.* ¶ 6.6.5.

113. *Id.* ¶ 6.6.2.

114. *Id.* ¶ 6.6.2(1).

115. *Id.* ¶ 6.6.2(3).

116. *Id.* ¶ 6.6.8(1).

expectations of probability and severity of credit events.[117] Also, the FSA states that a contract is less likely to be insurance "if it requires the provider to assume a speculative risk (i.e. a risk carrying the possibility of either profit or loss) rather than a pure risk (i.e. a risk of loss only)."[118] CDSs transfer the risk of loss only because credit events are always downside risks in terms of reference asset value.[119]

In the FSA guidance, the only factor against insurance characterization of CDSs is that a contract is *more likely* to be insurance if it "is described as insurance and contains terms that are consistent with its classification as a contract of insurance, for example, obligations of the utmost good faith."[120] However, this is not the case for CDSs. The guidance goes on to note that what matters is the substance, and the contract "does not cease to be a contract of insurance simply because the terms included are not usual insurance terms."[121] The question is *asymmetric:*

> Although there are good reasons for submitting anything that is frankly called insurance to insurance regulation, since the public might otherwise be misled, the test is clearly unsuitable when applied to business which is not called insurance for then an easy way to avoid the burden of regulation would be to use another name.[122]

Therefore, the use of insurance language renders insurance characterization *more likely*, but the avoidance of such language does *not* make insurance characterization *unlikely*.

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117. BANKS, GLANTZ & SIEGEL, *supra* note 16, at 34 ("The premium is a function of various factors, including time to maturity, probability of reference credit default, expected recovery rate given default[,]" etc.).

118. FSA, PERG, *supra* note 90, ¶ 6.6.8(2).

119. *See id.*

120. *Id.* ¶ 6.6.8(3).

121. *Id.* ¶ 6.6.8(4).

122. Hellner, *supra* note 83, at 500.

C. POTTS OPINION: THE LEADING ARGUMENT THAT CDSS ARE NOT INSURANCE

1. The Potts Opinion and Its Importance

The argument for insurance recharacterization seems strong, but there is a persistent belief that CDSs are not insurance. This belief goes back to a legal opinion on credit derivatives penned in 1997 by Robin Potts QC in London for ISDA.[123] After examining the principles, Potts concluded:

> I think that credit default options [sic] plainly differ from contracts of insurance in the following critical respects:-
>
> (a) the payment obligation is not conditional on the payee's sustaining a loss or having a risk of loss; [and]
>
> (b) the contract is thus not one which seeks to protect an insurable interest on the part of the payee. His rights do not depend on the existence of any insurable interest.[124]

Potts went on to admit that "the economic effect of certain credit derivatives can be similar to" insurance but "is not the test to be applied to the characterisation of the transaction."[125] Instead, the question depends on the intended rights and obligations specified in the contract.[126] Potts also recommended that the contract include a clause insisting that the parties wish the obligations to exist, regardless of whether the protection buyer suffers or is exposed to a loss, so that the transaction would not be an insurance contract.[127]

Before critically analyzing Potts' reasoning, it is worth noting its importance. In the words of an anonymous ISDA representative, "there would have been no market at all" in CDSs in the absence of the Potts opinion.[128] ISDA has repeated the core of Potts's argument on

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123. *See* POTTS OPINION, *supra* note 49, ¶ 1.

124. *Id.* ¶ 5.

125. *Id.*

126. *See id.*

127. *See id.* ¶ 6.

128. Isabelle Huault & Hélène Rainelli-Le Montagner, *Market Shaping as an Answer to Ambiguities: The Case of Credit Derivatives*, 30 ORG. STUD. 549, 560 (2009).

numerous occasions.[129] The rhetorical weight of the Potts opinion has been so impressive that in a 2006 letter to the English Law Commission, ISDA Senior Policy Director Richard Metcalfe invoked the authority of the "widespread acceptance of the so-called 'Potts opinion,'" which had come to represent "current market consensus."[130]

In reality, though, that widespread acceptance was driven by a group of London-based banking lawyers basically repeating the Potts opinion in a range of publications.[131] For example, a group of Allen & Overy solicitors—connected with the Potts opinion itself—made the same argument in 1997.[132] In 2001, Norton Rose lawyers advanced essentially the same argument,[133] and in 2003, ISDA documentation expert Paul Harding referred to the Potts opinion as definitive.[134] Likewise, Joanna Benjamin in 2007 wrote—while expressing doubts about the accuracy of Potts' analysis—that "given the degree of authority commanded by the Potts opinion in the financial markets, and given also the importance of commercial expectations in characterising financial contracts, the opinion may now be regarded as conclusive."[135]

2. Mixed Reception

Determining whether the Potts opinion is conclusive involves complex legal issues that the following sections examine in detail, but

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129. *See, e.g.*, Letter from Robert G. Pickel, Exec. Dir. & CEO, ISDA, to Ernst N. Csiszar, President, NAIC & Robert Esson, Senior Manager, Global Ins. Mkts., NAIC (Feb. 23, 2004), *available at* http://www.isda.org/c_and_a/pdf/NAICltr022304.pdf (arguing that weather derivatives are not insurance).

130. Letter from Richard Metcalfe, Int'l Swaps & Derivatives Ass'n, to the Law Comm'n (Apr. 18, 2006), *available at* http://www.isda.org (responding to Insurance Contract Law: A Joint Scoping Paper).

131. *See, e.g.*, Mugasha, *Syndicated Loans*, *supra* note 28, at 222–23 (summarizing arguments similar to the Potts opinion).

132. David Benton, Patrick Devine & Philip Jarvis, *Credit Derivatives Are Not Insurance Products*, 16 INT'L FIN. L. REV. 29, 30–31 (1997). Benton was one of the two Allen & Overy Instructing Solicitors acting for ISDA in requesting the Potts opinion. *See* Allen & Overy, Instructions to Counsel, at 10 (May 19, 1997) [hereinafter Potts Instructions] (on file with author).

133. Maria Ross & Charlotte Davies, *Credit Derivatives and Insurance – a World Apart?*, *in* LLOYDS, ARTWORK 2 (2001).

134. PAUL C. HARDING, A PRACTICAL GUIDE TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 18–19 (2004).

135. BENJAMIN, *supra* note 80, at 142 n.426.

generally, the assessments of Harding and Benjamin seem hasty at best. The Potts opinion is famous, but legally, it is only a private opinion. Its acceptance by the market—that is, a financial market keen to free itself from the shackles of regulation—is hardly surprising, and certainly does not render it conclusive.

Moreover, the acceptance of the Potts opinion has been hugely exaggerated. In fact, already in 1998, Professor Hudson wrote that credit derivatives basically provide "a form of insurance policy for the buyer"[136] and that they imply "a number of areas of potential liability where dealers are, in terms, providing insurance to their clients."[137] In 2000, John Jakeways advanced a more nuanced position on the insurance question. In his view, the answer should depend on the specific terms of each contract, and, while many credit derivatives might escape insurance law, nothing certain could be said.[138] Ali and de Vries Robbé, in 2005, likewise highlighted the continuing legal risk that credit derivatives might be recharacterized as insurance.[139] Finally, Benjamin Saunders, in 2010, argued that at least some CDSs—"for example a bank entering a CDS to protect against borrower default"—are "a form of indemnity insurance."[140]

Just as academic opinion has diverged from Potts on many points, Potts' reception by regulators has been equally mixed. In the U.K., the FSA explicitly commented on the Potts opinion in 2002, arguing that the Potts opinion should not be relied upon.[141] The same suspicion was

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136. Alastair Hudson, Seller Liability for Credit Derivatives 5 (July 1998), *available at* http://www.alastairhudson.com/financelaw/sellerliabilitycreditderivs.pdf.

137. *Id*. at 14.

138. John Jakeways, *The Legal Nature of Credit Derivatives*, in CREDIT DERIVATIVES: LAW, REGULATION AND ACCOUNTING ISSUES 47, 51–53 (Alastair Hudson ed., 1999). It seems correct that the issue depends on the specific terms of the contract. However, Jakeways also suggested that the basis for avoiding insurance law is that the *principal object* of the transaction is other than to insure. *Id*. at 54–55. But as we have seen, the principal object test is doubtful and has been expressly rejected in the U.K. *See supra* notes 103–05 and accompanying text.

139. *See* Paul U. Ali, *Credit Derivatives and Synthetic Securitizations: Innovation and Fragility*, 20 BANKING & FIN. L. REV. 293, 308 (2005); Paul U. Ali & Jan Job de Vries Robbé, *New Frontiers in Credit Derivatives*, 6 J. BANKING REG. 175, 181 (2005).

140. Saunders, *supra* note 6, at 435.

141. *See* FIN. SERVS. AUTH., CROSS-SECTOR RISK TRANSFERS, Annex B, at 2 (2002), *available at* http://www.fsa.gov.uk/pubs/discussion/dp11.pdf [hereinafter FSA, RISK TRANSFERS]. The reasons were: (i) some contracts may not have "no intention to insure" clauses; (ii) the reference event may have been defined in such a way that it is

repeated by the English and Scottish Law Commissions' 2008 study on insurable interest.[142] In the U.S., ISDA's Potts-like argumentation was initially accepted by insurance regulators[143] but after the financial crisis, was more carefully scrutinized and then rejected.[144]

D. FORM AND SUBSTANCE IN INSURANCE LAW AND CDSS

This section examines the arguments of Potts in more detail. The easiest issue to tackle concerns the relationship between the legal form of a transaction and its so-called substance. Given that CDSs are functionally very much like insurance, the question is whether their legal recharacterization can be avoided by shunning the language of insurance or by inserting "no intention to insure" clauses. The brief answer is negative, but the matter merits a closer look, as it reveals some fundamental points about insurance law and CDSs.

1. Insurance Law: The Primacy of Substance over Form

Insurance regulation is not voluntary, and it cannot be avoided simply because the parties wish to do so. It is, therefore, universally established that in insurance law, substance matters more than form.[145] This raises the question of what *substance* means.

In English law, the notion of substance refers fundamentally to the *obligation(s)* of the *insurance provider*.[146] In CDS transactions, the obligation of the protection seller is to compensate for the loss of

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conceptually impossible for the event to occur without the protection buyer suffering a loss; (iii) there are also contracts of insurance that do not provide indemnity against actual loss; and (iv) "no intention to insure" clauses may not be definitive if there is evidence of a different true intention. *Id.*

142. *See* LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶¶ 7.10–7.17. They also noted the industry pressure against recharacterizing credit derivatives as insurance. *Id.* ¶ 7.11.

143. *See infra* Part II.H.1.

144. *See infra* Part II.H.3.

145. On U.S. law, *see* Hellner, *supra* note 83, at 500 ("Directly or indirectly this [formal] test is rejected almost universally. It is not the term used, but the characteristic features of the activity that are held decisive."). On English law, see FSA, PERG, *supra* note 90, ¶ 6.5.4(1) ("[M]ore weight attaches to the substance of the contract, than to the form of the contract.").

146. *See* FSA, PERG, *supra* note 90, ¶ 6.5.4(2) (citing *In re Sentinel Securities* (1996) 1 WLR 316).

reference asset value following a credit event because the protection seller assumes the credit risk in return for periodic consideration.[147]

Substance does not mean merely the "economic effect" of the contract. For example, a farmer may enter into a commodity futures transaction for hedging purposes, but the agreement does not thereby become an insurance contract.[148] Contrary to Potts and his instructing solicitors,[149] the substance of the transaction does *not* refer to the intentions, motivations, or investment strategies of the parties. The FSA specifically states that it "is unlikely to treat the provider's or the customer's intention or purpose in entering into a contract as relevant to its classification."[150]

The case law in the U.S. and England reveals that insurance law has been applied to many transactions in which the parties might have been unaware that they effected insurance, because the rights and obligations were essentially those of insurance.[151] Of special interest for present purposes is the English case of *Fuji Finance v. Aetna Life Insurance*,[152] which concerned the legal nature of a financial transaction that consisted of a single premium capital investment bond that was used as a form of life insurance.[153] At first instance, the court ruled that the contract was not insurance because there was no sufficiently close connection between the benefit and the adverse event.[154] However, the Court of

147. *See supra* notes 16–18 and accompanying text.

148. *See* Henderson, *Credit Derivatives Are Not "Insurance," supra* note 3, at 4.

149. *See* Potts Instructions, *supra* note 132, at 8 (referring to prior discussions in which, according to Potts, the construction of a contract depends on "the rights, obligations and intentions of the parties" at the time of contracting); POTTS OPINION, *supra* note 49, ¶ 4 (arguing that construction must depend on "the object of both parties" because "otherwise some non-disclosed desire" by one party might turn the transaction into an insurance contract).

150. FSA, PERG, *supra* note 90, ¶ 6.5.4(2).

151. In the U.S., consider, for example, the numerous burial contract cases. *See* Hellner, *supra* note 83, at 509–10. In England, an amusing example is *Dep't of Trade & Indus. v. St. Christopher Motorists' Ass'n Ltd.* (1974) 1 All E.R. 395, where a motorist association's promise to provide chauffeur services to its members if they lost their driving license as a result of being convicted of having too much alcohol in the blood was considered insurance.

152. *Fuji Fin. Inc. v. Aetna Life Ins. Co.* (1996), 4 All ER 608.

153. *See* LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶ 7.25 n.21 (summarizing the case and its history).

154. *See Fuji Fin. Inc. v. Aetna Life Insurance Co. Ltd* (1994) 4 All ER 1025. According to LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶ 7.25 n.21,

Appeals reversed the ruling and held that the transaction constituted insurance, following a broad definition of life insurance.[155]

Care should be exercised when drawing analogies from *Fuji* because the case involved peculiar facts and life insurance. It is clear, however, that the *Fuji* decision, at first instance, cannot be relied upon (as was done by Potts' instructing solicitors) to argue that a contract cannot be insurance when it has an investment element.[156]

2. Transformers: The Sham Paradox

In order to more clearly perceive that the rights and obligations in CDS transactions are essentially those of an insurance contract, it is useful to consider so-called transformer arrangements. In these agreements, CDSs are sometimes explicitly transformed into insurance contracts in order to exploit differences between regulatory regimes in banking and insurance (*i.e.*, regulatory capital, tax, and accounting differences).[157] In a typical arrangement, a transformer company would first write the original CDS, and an authorized insurer would then insure the transformer company by way of traditional insurance or financial guaranty insurance.[158]

This arrangement is especially revealing when the insurance leg incorporates the CDS terms "back to back."[159] Some lawyers have discouraged the incorporation of ISDA's CDS documentation into the insurance contract because this creates the risk that a court will hold that the insurance policy written through the transformer was a sham.[160] However, writing independent terms and different provisions creates

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"there was uncertainty about when the money would become payable and it did not chiefly depend on the length of the insured life."

155. *See Fuji Fin. Inc.* (1996) 4 All ER at 618 (finding that the essence of life insurance is that "the right to benefits is related to life or death").

156. *See* Potts Instructions, *supra* note 132, at 8 (arguing this). The interpretation of the *Fuji* cases is more nuanced in POTTS OPINION, *supra* note 49, ¶ 4.

157. *See* FSA, RISK TRANSFERS, *supra* note 141, ¶¶ 3.25–3.29, 3.67, 3.107, 3.116; *id.* Annex A; *id.* Annex B, at 3–4 (discussing the structure, logic and implications of transformers); Ross & Davies, *supra* note 133, at 4–5 (describing transformers).

158. *See* FSA, RISK TRANSFERS, *supra* note 141, Annex B, at 3.

159. *Id.*

160. *See* Ross & Davies, *supra* note 133, at 4–5; FSA, RISK TRANSFERS, *supra* note 141, Annex B, at 4, and ¶ 3.108.

unwanted risks, and the FSA, in 2002, estimated that the standard approach had been to incorporate ISDA documentation.[161]

The existence of transformers—and the incorporation of CDS terms—highlights the difficulty of claiming that CDSs *differ* from insurance in terms of the rights and obligations. Such a claim would imply that two contracts that have *exactly the same terms* are governed by entirely different legal rules and regulatory regimes, even though insurance law is supposed to be determined by substance rather than form.

There is also another paradox. Some lawyers have argued that the *insurance leg* of the transformer arrangement might be construed as a sham, *e.g.*, an illicit derivatives transaction (into which an insurance company would be prohibited from entering) masked as an insurance contract. Yet, it could be argued that the *CDS leg* is a sham, *e.g.*, an illicit insurance contract masked as a derivative. These two prospects cannot both be true at the same time, and this Article submits that the latter view is better.

3. Where Is the Swap in a Credit Default Swap?

Some have argued that the deliberate avoidance of insurance language could be interpreted *in favor* of insurance classification if there is evidence of deliberate evasion of insurance regulation.[162] The relevance of that viewpoint becomes manifest when one asks the apparently childish question: *where is the swap in a credit default swap?*

A "swap is a private agreement between two parties *to exchange cash flows* at certain times according to a prearranged formula."[163] In other words, a "swap is *an exchange of cash flows*. A cash flow is a series of future cash payments."[164] However, a CDS is *not* an exchange of cash flows and *definitely* is not an exchange of credit defaults.[165] CDSs bear no functional resemblance to genuine swap agreements "[b]ecause the transaction is unilateral . . . , [so] it does not take the form

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161. FSA, RISK TRANSFERS, *supra* note 141, Annex B, at 4, and ¶ 3.77.

162. *See supra* note 107 and accompanying text.

163. Partnoy, *Regulatory Arbitrage*, *supra* note 33, at 219 (emphasis added).

164. Feder, *supra* note 21, at 701 (emphasis added); *see also* Schuyler K. Henderson, *Regulation of Swaps and Derivatives: How and Why?*, 8 J. INT'L BANKING L. 349, 349 (1993) [Henderson, *Regulation of Swaps and Derivatives*] (providing a longer but similar description of swaps).

165. *See* Henderson, *Regulation of Swaps and Derivatives*, *supra* note 164.

of a standard OTC swap contract, which is always bilateral."[166] Also, "[u]nlike other types of derivatives such as interest rate swaps, the risks assumed by the protection buyer and the protection seller in a CDS transaction are not symmetrical."[167] It is hard to avoid the conclusion that the emperor has no clothes: there is no swap in a CDS.

E. INSURABLE INTEREST

Potts correctly stated that legal construction depends on the rights and obligations specified in the contract.[168] However, the parties may specify that they wish the contract to be valid even if the buyer has no insurable interest. This section addresses whether this contract thereby becomes a non-insurance contract.

1. The Requirement of an Insurable Interest

Contrary to the Potts opinion and the claims of ISDA and others, insurable interest is not a demarcating factor of insurance law but rather, a requirement of *validity* in insurance. "Every contract of insurance requires an insurable interest to support it; otherwise, it is invalid."[169] In other words, "insurable interest . . . is a requirement for a *valid* contract of insurance and not itself a defining feature of the contract."[170]

The standard explanation for the doctrine of insurable interest is that it reduces the risk of contracts that tempt the insured to bring about the loss insured against.[171] This rationale is debatable,[172] but this much is clear: the requirement of insurable interest is *imposed by law*, not by the contracting parties. When the protection buyer has no insurable

166. BANKS, GLANTZ & SIEGEL, *supra* note 16, at 33.

167. Ayadi & Behr, *supra* note 30, at 182.

168. *See supra* note 126 and accompanying text.

169. E.R.H. IVAMY, GENERAL PRINCIPLES OF INSURANCE LAW 23 (1993); *see also* CLARKE, *supra* note 82, at 26.

170. FSA, INSURANCE, *supra* note 109, ¶ 2.10.

171. *See* Hazen, *supra* note 87, at 420–22 (describing the origin of the insurable interest doctrine).

172. *See* CLARKE, *supra* note 81, at 36–37 (critically discussing the traditional insurable interest doctrine).

interest, the contract becomes an invalid insurance contract, not a non-insurance contract.[173]

2. The Relationship Between Adverseness and Insurable Interest

Perhaps, the misunderstanding of Potts and others is due to the belief that an insurable interest merely means that "an insurance contract must be a contract against the risk of loss."[174] However, this formulation would merge insurable interest with the notion of *adverseness*. There is some *obiter dicta* support for this view,[175] but it seems to have been an unintended inaccuracy.[176] The standard view is that adverseness is a wider notion than the legal requirement of insurable interest.[177]

It would be incorrect to argue that CDSs are not insurance when the default of the reference obligations is not adverse to the protection buyers, because that treatment confuses adverseness with insurable interest. Although the notion of an uncertain and adverse event tends to be underdefined,[178] it essentially refers to the *nature* of the event, which must constitute a risk of loss for there to be insurance, whereas "insurable interest" refers to legal restrictions on *who is permitted* to purchase insurance on that event.[179]

In property insurance, the existence of a transferable risk can normally be determined objectively, and credit default is "a risk of loss only,"[180] much like fire, accident, or other property damage. It is not insignificant that standard CDS terminology refers to "protection buyer" and "protection seller."[181] To be sure, persons who stand to benefit from

173. Kimball-Stanley, *supra* note 3, at 248–49; *see also* FSA, RISK TRANSFERS, *supra* note 141, Annex B, at 1 (noting this, and pointing out that some CDS buyers lack an insurable interest).

174. POTTS OPINION, *supra* note 49, ¶ 4.

175. In the English case *Medical Def. Union Ltd. v Dep't* (1979) 2 All ER 421, at 423–24, Megarry VC used the notion of "insurable interest" as a defining element of insurance law.

176. *See id*. Megarry was referring to *Prudential*, where the third element is adverseness, not insurable interest. *See supra* note 91 and accompanying text.

177. *See* LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶¶ 7.20–7.23 (summarizing literature to this effect).

178. *See id.* (citing different expressions).

179. *See id.* at 7.23.

180. *See supra* note 118 and accompanying text.

181. *See supra* note 16 and accompanying text.

the occurrence of the adverse event would view those events positively (*i.e.*, someone would benefit from a fire at a competitor's premises), but that does not affect the point: a fire insurance policy taken by an arsonist is not a *permitted non-insurance contract* (for want of subjective adverseness), but as an *invalid insurance contract* (for want of insurable interest). Therefore, because conflating adverseness and insurable interest would effectively abolish the requirement of insurable interest, such treatment cannot be the meaning of the law.

3. Practical Consequences

Applying insurance law to CDSs would imply that some contracts would be invalid. The general rule in property insurance is that the protection buyer must have an "economic interest"[182] (e.g., a "'factual expectation' of loss") in the property. [183] Importantly, this corresponds to an economic notion of hedging that is much broader than a requirement of holding the underlying debt. English courts have traditionally been restrictive, requiring "'a legal or equitable relation' to the property," [184] but recently, more liberal approaches have been adopted.[185]

Although the matter is debatable, the requirement of an insurable interest would address the widely raised concerns related to CDS speculation. [186] Creating targeted rules for CDSs could reduce the consequential legal uncertainty.[187]

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182. *See, e.g.*, N.Y. INS. LAW § 3401 (McKinney 2014).

183. CLARKE, *supra* note 81, at 31 (citing *Lucena v Craufurd* (1806), 2 Bos & Pul (NR) 269 (HL)). The rule is similar in most common law countries, and in countries such as France and Germany, the only requirement is proof of loss at the time of claim. *See id.* at 32.

184. CLARKE, *supra* note 81, at 31 (citing *Macaura v Northern Assurance Co.* [1925] AC 619).

185. *See* LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶¶ 5.16–5.19 (discussing Lord Justice Waller's analysis in *Feasey v Sun Life Assurance Co.* [2003] EWCA Civ 885).

186. *See supra* notes 2, 42–43 and acompanying text.

187. *See* Juurikkala, *EU Short Selling Regulation*, *supra* note 11, ¶ 2 (discussing this approach in the European Short Selling Regulation).

F. LOSS INDEMNITY

A related but distinct source of confusion is the notion of loss indemnity. This section addresses whether CDSs are indemnity or non-indemnity contracts, and whether that distinction matters for their legal classification. The below analysis leads to the conclusion that CDSs are normally indemnity insurance contracts, although they may sometimes be non-indemnity insurance contracts.

1. Are CDSs Indemnity or Non-Indemnity Insurance?

The difference between indemnity and non-indemnity (also called contingency) insurance refers to the way that compensation is calculated. In indemnity insurance, payment is made according to "actual measurable loss" whereas non-indemnity insurance involves "a pre-determined sum."[188] Non-indemnity contracts are common in life and personal accident insurance because it is difficult to translate those harms into monetary terms, so predetermined compensation reduces costs and uncertainty.[189]

Which type is a CDS? Given that it promises payment regardless of proof of loss suffered by a CDS buyer, it might seem like a non-indemnity contract.[190] However, this is inaccurate: the legal distinction is not based on the requirement of proof of loss but rather, on whether compensation is determined *ex ante* or *ex post*. CDS payments are calculated *after the event* and according to the loss of value of the reference obligations, not according to a pre-determined lump-sum amount.[191] CDSs do not refer to *personal* loss by the protection buyer, but that is irrelevant. What matters is that compensation depends on the loss of value of the reference assets, and this is the case in both physical and cash settlement procedures.[192] Therefore, CDSs function like any

188. CLARKE, *supra* note 81, at 27.

189. *Id.*

190. *See* LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶ 7.9 ("In essence they [credit derivatives] "fulfil many of the common law definitions of non-indemnity insurance."). Unfortunately the reasons for that view are not elaborated.

191. On the level of principle, there is agreement that "non-indemnity contracts . . . pay a lump sum regardless of the amount . . . that is lost." *Id.* ¶ 7.14.

192. Physical settlement implicitly provides full compensation, whereas cash settlement as based on an approximation of the loss of value. *See supra* note 23 and accompanying text.

indemnity transaction and differ essentially from non-indemnity insurance.[193]

According to a different interpretation, *covered* CDSs, which "*are* designed to indemnify the protection buyer against loss suffered due to default . . . for example a bank entering a CDS to protect against borrower default . . . are in essence a form of indemnity insurance."[194] In contrast, *uncovered* CDSs would be contingency transactions.[195] However, this analysis confuses two different questions. The first distinction, between covered and uncovered transactions, refers to the *risk position of the protection buyer*, which depends on extra-contractual factors and is relevant for determining whether the purchaser has an insurable interest. The second distinction, between indemnity and contingency insurance, refers to the *calculation of the payment amount* and depends on the contract terms. Even covered CDSs are non-indemnity transactions if the payment amount is predetermined rather than calculated after the fact. Similarly, uncovered CDSs are indemnity transactions if the payment amount is calculated by reference to a loss of value.

2. Non-Indemnity Insurance in Property

The distinction has some practical implications, but they are not fundamental.[196] There is confusion here too, as some commentators have supposed that if CDSs are non-indemnity transactions, they could not be re-characterized as insurance.[197]

However, that is incorrect because non-indemnity insurance is a recognized category of non-life insurance too.[198] In addition to personal accident insurance, there are non-indemnity contracts in property

193. *See Medical Def. Union Ltd. v Dep't* (1979) 2 All ER 42, 422 (noting that in indemnity insurance, "the measure of the loss is the measure of the payment", whereas in contingency insurance, "[t]he sum to be paid is not measured by the loss but is stated in the policy").

194. Saunders, *supra* note 6, at 435.

195. *See id.*

196. For example, the timing of the insurable interest requirement is different. *See* CLARKE, *supra* note 81, at 27.

197. *Id.* ("As there is not generally recognised category of contingency insurance, and these types of CDS are not contracts of life insurance, they escape regulation as insurance products.").

198. *See* LAW COMMISSIONS, INSURABLE INTEREST, *supra* note 92, ¶¶ 1.17, 3.64–3.68, 7.42 (discussing non-life, non-indemnity insurance).

insurance, such as "insurance policies on land, buildings, ships, goods and merchandise," paying "a fixed sum on the destruction of these items."[199] These policies "do not require the policyholder to have suffered a loss."[200]

G. WEAK POLICY ARGUMENTS AGAINST RE-CHARACTERIZING CDSS AS INSURANCE

Perhaps, the only reasonable argument against re-characterizing CDSs as insurance is that insurance law should not apply for practical reasons. For example, one claim is that CDSs should be subject to insurance law because the "fundamental objectives of many CDS transactions set them apart from garden-variety insurance contracts."[201] However, the fundamental objective of *covered* CDSs is precisely an insurance objective.[202] The rest (uncovered CDSs) are speculative bets on borrower default that raise important policy concerns like those that gave rise to the insurable interest requirement.[203]

According to another argument, the regulations that accompany insurance products are not needed because "virtually 100% of both the protection buyers and sellers are institutional investors, with the public having no exposure, or virtually none, to these contracts."[204] However, the second part of this claim is manifestly untrue. Firstly, the public has an interest in the stability of the financial system, which recent experience shows can be fundamentally devastated by sizable CDS contracts sold without sufficient loss reserves.[205] Secondly, uncovered CDSs enable investors to take directional bets that otherwise would be prohibited and that demonstrably have an adverse effect on the borrowing costs for many companies.[206]

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199. *Id.* ¶ 7.42.

200. *Id.* ¶ 7.14.

201. Schwartz, *supra* note 4, at 182.

202. This view is acknowledged even by Henderson, *Credit Derivatives Are Not "Insurance"*, *supra* note 3, at 4.

203. *See id.*

204. Nirenberg & Hoffman, *supra* note 79, at 15; *see also* Schwartz, *supra* note 4, at 182 (supporting this argument); Henderson, *Credit Derivatives Are Not "Insurance," supra* note 3, at 45–46 (arguing that, with CDSs, there is no need for consumer protection).

205. *See supra* notes 37–41 and accompanying text; Saunders, *supra* note 6, at 445–447 (presenting reasons why CDSs create systemic risks).

206. *See supra* note 43.

A third argument is that CDSs have become so commonly treated as unregulated derivatives that re-characterizing them would destabilize financial markets.[207] However, legislative reform that includes a transition period could re-characterize CDSs without disrupting the markets.[208]

A more complicated argument that calls for further investigation is that insurance law would impose unnecessary costs without solving problems.[209] For the time being, it is important to avoid such exaggerations, such as the assertion that "[c]redit derivatives help complete these [loan] markets by allowing the bank to offload the risk to investors who can more efficiently bear it."[210] In reality, the risks are often sold to investors who are simply more lightly regulated, such as unregulated hedge funds.[211] Moreover, the creation of a targeted regulatory regime for CDSs would improve the suitability of insurance regulation.[212] Therefore, these arguments against re-characterizing CDSs as insurance are flawed, unsubstantiated, or speculate downsides that could be prevented.

H. THE EVOLVING POSITION OF U.S. INSURANCE REGULATORS

The thinking of U.S. insurance regulators concerning CDSs has evolved substantially, so a chronological analysis is best to understand this change. The evolution reveals the complex interplay of legal, financial, and political forces at state and federal levels.[213]

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207. *See supra* note 135 and accompanying text (emphasizing commercial expectations).

208. *See id.*

209. *See* Henderson, *Credit Derivatives Are Not "Insurance," supra* note 3, at 46–55 (arguing to this effect).

210. *Id.* at 29.

211. *See supra* note 41; Wynkoop, *supra* note 55, at 3105–07 (explaining how hedge funds are involved in credit derivatives and create systemic risks).

212. For example, *see* Saunders, *supra* note 6, at 441–42 (proposing CDS issuers be subject to prudential regulation, without subjecting CDSs to the regulation of insurance contracts generally).

213. Insurance regulation in the U.S. is principally determined at state level, based on the McCarran Ferguson Act of 1945, which has been criticized. *See* Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y. U. L. REV. 13 (1993), *available at* http://digitalcommons.law.yale.edu/fss_papers/1605/.

1. The New York Opinion of 2000

U.S. insurance regulators first touched upon the question of credit derivatives in 2000 to respond to an inquiry from the banking industry when the General Counsel of the New York State Insurance Department ("NYSID") opined that *credit default options* are not insurance contracts if the contractual payment does not require that the protection buyer suffered a loss.[214] Although the opinion was non-binding and did not necessarily extend to all CDSs,[215] it was relied upon,[216] and New York insurance regulators did not interfere with the CDS market until 2008.[217]

2. The 2003 White Paper on Weather Derivatives

The first signs that not all insurance regulators agreed with the opinion of the NYSID General Counsel appeared in 2003, when the U.S. National Association of Insurance Commissioners (NAIC) drafted a White Paper inquiry into weather derivatives.[218] The draft, entitled *Weather Financial Instruments (Temperature): Insurance or Capital Markets Products?*, took the view that weather derivatives

> appear to be disguised as "non-insurance" products to avoid being classified and regulated as insurance products. In fact, there is evidence that the promoters of these products go to great lengths to be sure that the energy companies involved do not use terms that naturally describe what is taking place—namely the transfer of risk from a business to another professional risk taker.[219]

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214. *See* Kimball-Stanley, *supra* note 3, at 247 (quoting Re: Credit Default Option Facility, NY Dep't of Ins. Gen. Counsel June 16, 2000) ("Indemnification of loss is an essential indicia of an insurance contract which courts have relied upon in the analysis of whether a particular agreement is an insurance contract under New York law. Absent such a contractual provision the instrument is not an insurance contract.").

215. Robert S. Bloink, *Does the Dodd-Frank Wall Street Reform Act Rein In Credit Default Swaps? An EU Comparative Analysis*, 89 NEB. L. REV. 587, 618 (2011).

216. *See id.*

217. *See id.*

218. *See* Ali & de Vries Robbé, *supra* note 139, at 180–81; Kimball-Stanley, *supra* note 3, at 250.

219. *See* Kimball-Stanley, *supra* note 3, at 250 (citing PROPERTY & CASUALTY INS. COMM., WEATHER FINANCIAL INSTRUMENTS (TEMPERATURE): INSURANCE OR CAPITAL MARKET PRODUCTS? (Sept. 2, 2003)).

The draft White Paper thus argued that weather derivatives are insurance contracts and should be regulated as such. Although it covered only weather derivatives, the position and reasoning of NAIC was "equally applicable to credit derivatives."[220] The derivatives industry was extremely worried about the White Paper and commenced an intense lobbying effort headed by ISDA.[221] The ISDA argued that the "Draft White Paper's logic could extend to a broad array of derivatives and would create substantial and disruptive regulatory uncertainty."[222] Soon after, NAIC not only shelved the regulatory plans but also withdrew the White Paper from publication.[223]

3. Reconsideration After the Financial Crisis of 2008

The financial crisis of 2008 generated new interest in the matter. In September 2008, NYSID Superintendent Eric Dinallo wrote a Circular Letter that essentially reversed the position of the NYSID: "the making of the CDS itself may constitute 'the doing of an insurance business' within the meaning of Insurance Law § 1101, [in which case,] the protection seller should be licensed as an insurer."[224]

Dinallo's reasoning was not entirely clear at this stage. Trying to maintain the 2000 non-binding opinion, he argued that the opinion "did not grapple with whether . . . a CDS is an insurance contract when it is purchased by a party who, at the time at which the agreement is entered into, holds, or reasonably expects to hold, a 'material interest' in the referenced obligation."[225] In a testimony before a Senate Committee, Dinallo pointed out that the 2000 opinion had been given in response to "a very carefully crafted question" that did not cover the CDS market as

220. Ali & de Vries Robbé, *supra* note 139, at 180.

221. *See* Letter from Joshua D. Cohn, U.S. Legal Counsel, ISDA, to Ernst N. Csiszar, President, NAIC (Jan. 6, 2004), *available at* http://www.isda.org/speeches/pdf/NAICletter010604.pdf (explaining that "ISDA is extremely concerned" about the draft white paper); Letter from Robert G. Pickel, *supra* note 129 (arguing that weather derivatives are not insurance).

222. Letter from Robert G. Pickel, *supra* note 129, at 2.

223. ISDA, Member Update (Mar. 24, 2004), *available at* http://www.isda.org/c_and_a/pdf/NAICUpdate-032404.pdf (publicizing the success of the lobbying effort); Ali & de Vries Robbé, *supra* note 139, at 180–181; Kimball-Stanley, *supra* note 3, at 250.

224. Dinallo, *supra* note 70, at 7.

225. *Id.* at 7.

a whole.[226] So, he argued that *covered* CDSs were insurance contracts whereas "naked" (uncovered) CDSs were not.[227] As previously explained, this distinction arises out of confusion regarding the insurable interest doctrine.[228]

On the same day that the Circular Letter was published, New York Governor David A. Paterson announced that New York State would begin to regulate CDSs as insurance as of January 1, 2009.[229] This caused a barrage of criticism from the financial lobby and its legal representatives.[230] The question, however, was not whether insurance supervisors understood derivatives but whether CDSs *were insurance*—something that the supervisors presumably did understand.[231] It turned out that state insurance legislators were increasingly determined to answer the question in the affirmative.[232]

4. Plans to Regulate CDSs as Insurance

The banking industry wasted no time fighting the new plan to regulate CDSs as insurance. Criticism and lobbying must have been intense given that just two months after Superintendent Dinallo's opinion, he announced that "New York will delay indefinitely its

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226. Eric Dinallo, Testimony to the United States Senate Committee on Agriculture, Nutrition, and Forestry 5 (Oct. 14, 2008), *available at* http://www.dfs.ny.gov/about/speeches_ins/sp0810141.pdf. The exact question was: "Does a credit default swap transaction, wherein the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss, constitute a contract of insurance under the insurance law?" *See id.*

227. *Id.* at 3.

228. Insurable interest is not a factor of demarcation, but a requirement of validity. *See supra* Parts II.E.1–2.

229. *See, e.g.*, Danny Hakim, *New York to Regulate Credit Default Swaps*, N.Y. TIMES, C10 (Sept. 23, 2008), *available at* http://www.nytimes.com/2008/09/23/business/23swap.html.

230. Adam W. Glass, *Credit Derivatives as Insurance: In Race to Regulate CDS, Wrong Runner Takes Early Lead* (Oct. 2, 2008), at 5, *available at* www.linklaters.com/pdfs/publications/us/
021030_Prudence_Payback.pdf ("Let's hope [that] this ill-considered proposal can be promptly squelched, allowing the Insurance Department to go back to regulating something it understands—insurance.").

231. *See id.*

232. *See* Morelle, *supra* note 60, at 3 (describing the movement to regulate CDSs as insurance).

application of New York Insurance Law to CDS" in anticipation of federal regulation.[233] That seems to have been the last intervention of the NYSID in the matter.

However, the insurance movement continued. In 2009, the National Conference of Insurance Legislators ("NCOIL") prepared legislation that would regulate covered CDSs—defined as those whose buyers have a material interest in the reference entity—as *credit default insurance*, and the providers would be subject to state insurance regulations for credit default insurance corporations. In contrast, *naked* CDSs would be entirely banned.[234] The NCOIL Model Act for credit default insurance was essentially based on New York laws regulating financial guaranty insurance.[235] In April 2010, a New York State bill sought to regulate covered CDSs as financial guaranty products under New York Insurance Law and to ban naked CDSs.[236]

However, in a foreseeable response, the banking lobby sought federal preemption.[237] It became increasingly clear that the Obama administration was determined to federally regulate CDSs as derivatives and preempt their regulation as insurance.[238] Some Senators tried to get an insurable interest requirement into the Dodd-Frank Act, but that was

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233. Eric R. Dinallo, State of New York Ins. Dep't, First Supplement to Circular Letter No. 19, Re: "Best Practices" for Financial Guaranty Insurers (Nov. 20, 2008), *available at* http://www.dfs.ny.gov/insurance/circltr/2008/cl08_19s1.htm; *see also* Bloink, *supra* note 215, at 619 (noting that the plan was dropped under pressure from the banking industry).

234. *See* Davis Polk & Wardwell, *The National Conference of Insurance Legislators' Model CDS Bill* (June 3, 2009), at 3, *available at* http://www.davispolk.com/files/Publication/ea407c52-63cb-45b7-9bf0-7d9ce12400f1/Presentation/PublicationAttachment/2ccba63d-5ad8-4078-97fe-83aea7f2b70b/06.03.09.NCOIL .pdf (providing an overview of the draft model legislation); NCOIL, *NCOIL Moves to Regulate Credit Default Swaps*, Press Release (April 8, 2009), *available at* http://www.ncoil.org/HomePage/2009/0492009CDSCallPressRelease.pdf. The final version of the Model Act is *available at* http://www.ncoil.org/docs/cdsmodelact.pdf.

235. Davis Polk & Wardwell, *supra* note 234, at 2.

236. N.Y. Assembly A10783, 233rd Sess. (N.Y. 2010); Sidley Austin LLP, *Bill Introduced in New York Legislature to Regulate 'Credit Default Insurance' Based on NCOIL Model* (May 3, 2010), *available at* http://www.sidley.com/insurance_and_financial_services_update_050310.

237. Davis Polk & Wardwell, *supra* note 234, at 6.

238. *Id.* at 6.

rejected.[239] As a result, CDSs became regulated as derivatives instead of insurance.

III. CREDIT DEFAULT SWAPS AS DERIVATIVES

The analysis in Part III raises many follow-up questions. How is it possible that the application of insurance law to some or all CDSs was so widely ignored and so easily avoided? How could CDSs be globally established as unregulated "swaps" when they are economically not swaps at all? Why did the Dodd-Frank Act preempt insurance regulation seemingly without debate?[240] One might suggest that it simply took time for insurance regulators to grasp what these transactions really consisted of, but such an answer is far from complete.

This Part argues that the issue can only be understood in light of a longer historical evolution marked by two opposing forces: anti-speculation and pro-regulation initiatives on one side and anti-regulatory and regulation-evasive initiatives on the other. Part III.A briefly outlines the historical background of more recent developments. Then, Part III.B describes the leading role played by International Swaps and Derivatives Association in the creation of an unregulated space for OTC swaps. Finally, Part III.C analyzes the Dodd-Frank Act reforms and finds that, although they seek to rein in the excesses of modern finance, they paradoxically end up consolidating ISDA's largely unregulated swaps regime.

A. HISTORICAL BACKGROUND: LAW VS. FINANCE

1. Traditional Anti-speculation Law

The relationship between law and finance has been tense throughout history: legislators have placed various restrictions on financial activity, ranging from limits on interest-taking to a marked

239. *See* Ronald D. Orol, *Senators Reject Effort to End Debate on Bank Bill*, MARKETWATCH (May 19, 2010), http://www.marketwatch.com/story/rejection-of-democrat-measures-may-slow-bank-bill-2010-05-19 (discussing the Senate's rejection of Senator Dorgan's amendment, which would have imposed an insurable interest requirement on CDSs).

240. *See infra* note 378 and accompanying text.

hostility towards speculative activities.[241] In particular, the law of many countries traditionally viewed gambling as a socially undesirable activity, either prohibiting or heavily regulating it.[242] The law's disdain of gambling was not limited to cards and casino, as also "investing, hedging, and insurance have been compared with gambling and, to varying degrees, social distaste for gambling has been used as a rationale for regulation of these other activities."[243] Thus, for example, common law courts frequently refused to enforce commodity forward contracts—often called *difference contracts*—if they were perceived as speculative wagers instead of hedging transactions.[244]

2. The Rise of Private Orderings

Insofar as the only problem was the refusal to enforce the contracts, market participants found a way to avoid the restrictions by way of *private orderings*, i.e. by creating extra-legal arrangements for enforcing contracts without resorting to courts.[245] The leading example is the commodity exchanges created since the mid-19th century, developing mechanisms for not only trading physical commodities, but also speculating in changes in price in ways that could be enforced without courts.[246] Over time, the exchanges created a self-regulatory system

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241. Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 703 (1999) [hereinafter Stout, *Speculators*]

242. *See, e.g.*, Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARVARD BUS. L. REV. 1, 12–13 (2011) [hereinafter Stout, *Legal Origin*], *available at* http://www.hblr.org/download/HBLR_1_1/Stout-Derivatives_and_the_Credit_Crisis.pdf (discussing the traditional common law approach); Hazen, *supra* note 87, at 377 ("[G]ambling is not generally viewed as a productive activity or one that provides any benefit to society beyond its entertainment value [which] is generally seen as outweighed by the social costs of gambling.").

243. Hazen, *supra* note 87, at 377.

244. *See* Stout, *Legal Origin*, *supra* note 242, at 11–12 (discussing cases); Stout, *Speculators*, *supra* note 241, at 712–34 (discussing a range of U.S. "antispeculation" laws, both in common law and statute).

245. *See, e.g.*, Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

246. *See* Stout, *Legal Origin*, *supra* note 242, at 14–15 (describing this development). For a detailed study, *see* Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States, 1875-1905*, 3 AM. HIST. REV. 307 (2006).

consisting of "membership standards, collateral ('margin') posting requirements, capital requirements, and standardized contract terms".[247]

One interesting aspect of the legal evolution is that the success of respectable exchanges also attracted secondary business—so called "bucket shops"—which copied the betting opportunities without imposing membership requirements.[248] These contracts were in many ways analogous to what now are called "over-the-counter" derivatives.[249] However, many U.S. states criminalized these OTC activities with the so-called "anti-bucketshop" laws; the exchanges started their parallel attacks against price quotation stealing, and were backed by the courts.[250] In summary, speculative derivative contracts were permitted, but only within self-regulatory spaces.

3. The 1930s Regulatory Regime and Its Erosion

The self-regulatory regime for speculative contracts was shattered following the Great Crash of 1929, which reawakened the traditional anti-speculative attitudes.[251] This led to a new wave of federal legislation that still forms the backbone of U.S. financial regulation.[252] In relation to financial derivatives, the 1930s legislation had two principal effects. Firstly, in line with earlier common law and state anti-bucketshop statutes, the legislation—particularly the Commodity Exchange Act of 1936[253]—reinforced the prohibition of OTC speculative activities by requiring that all transactions take place in regulated exchanged (called "contract markets").[254] Secondly, it subjected the exchanges to public supervision under a hybrid regulatory system that combines elements of self-regulatory and command-and-control regulation, headed by the Securities and Exchange Commission

247. Stout, *Legal Origin*, *supra* note 242, at 16.

248. *Id.* at 16–17.

249. *Id.* at 17.

250. *Id*. at 16–17.

251. *See* David Hirshleifer, *Psychological Bias as a Driver of Financial Regulation*, 14 EUR. FIN. MGMT. 856, 861 (2008) (noting how the Crash caused an attack on speculators).

252. *See, e.g.*, Partnoy, *Derivatives Regulation*, *supra* note 53, at 429–33 (discussing the federal regime and its general problems with respect to derivatives).

253. Commodity Exchange Act, ch. 545, 49 Stat. 1491 (1936) (as amended).

254. Stout, *Legal Origin*, *supra* note 242, at 18 ("Federal law, like state antibucketshop statutes, went beyond the common law by making off-exchange futures illegal as well as judicially unenforceable.").

("SEC," for securities options) and the Commodity Futures Trading Commission ("CFTC," for commodity futures and options).[255]

Over time, however, this regime of contract-market monopoly was eroded by three principal factors. Firstly, market participants began to design novel contracts in order to fit them into exemptions to the regulated markets (a form of regulatory arbitrage).[256] Secondly, turf battles between the two regulators tended to widen the regulatory gaps, as there emerged difficulties in fitting new instruments into the traditional categories of "securities" and "futures."[257] Thirdly, especially from the 1980s onwards, the rule-book was increasingly liberalized: on one hand, many financial contracts were excluded from the ambit of gaming laws, and gambling itself was gradually legalized;[258] on the other hand, OTC derivatives were expressly deregulated by way of a process that is next described in detail.[259]

B. THE PATH TO UNREGULATED SWAPS: THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

Deregulated OTC derivatives have roots in the 19th century, but their spectacular growth and global consolidation is a more recent phenomenon, which cannot be understood without reference to the

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255. *See, e.g.*, PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION: VOLUME 1 § 2.02 (2004) (describing the system of contract market monopoly).

256. Hazen, *supra* note 87, at 390; *see also* JOHNSON & HAZEN, *supra* note 255, § 1.02[8] (describing the deterioration of the exchange monopoly).

257. Hazen, *supra* note 87, at 390; Partnoy, *Derivatives Regulation*, *supra* note 53, at 431–33 (describing turf battles).

258. *See* Hazen, *supra* note 87, at 396–97 (noting the liberalization of gambling laws). In the U.S., many states continue to have restrictive gambling laws, whereas in the U.K., gambling was drastically liberalized by the Gambling Act 2005 (UK). However, it had been emphasized earlier that *bona fide* commercial or financial transactions will not be held to be wagering contracts. *See Morgan Grenfell v Welwyn Hatfield District Council* [1995] 1 AER 1.

259. On the process in the U.S., see Stout, *Legal Origin*, *supra* note 242, at 18–22; on the U.K., see Colin Scott & John Biggins, *Public-Private Relations in a Transnational Private Regulatory Regime: ISDA, The State and OTC Derivatives Market Reform*, 13 EUR. BUS. ORG. L. REV. 309, 318–19 (2012) (explaining that the enforceability of purely speculative OTC derivatives was guaranteed first by section 60 the Financial Services Act 1986 (UK), and then by section 8 the Financial Services and Markets Act 2000 (UK)).

International Swaps and Derivatives Association.[260] The role of one organization should not be exaggerated, but there is no reason to be dismissive about ISDA which, according Frank Partnoy, has been "the most powerful and effective lobbying force in the recent history of financial markets."[261] According to Scott and Biggins, "[t]he influence of ISDA is undoubtedly a key factor in the public deregulation of OTC derivatives trading by legislators in the latter 20th century, especially in the US."[262] Flanagan agrees that "ISDA has played a key role in keeping the OTC derivatives industry self-regulated."[263]

1. ISDA's Origins and Activities

ISDA was born in the 1980s, when Wall Street investment banks began to develop novel over-the-counter derivatives transactions such as swaps.[264] A leading motivation for OTC derivatives was regulatory arbitrage, as it was thought that "swaps were unregulated and immune from most securities-law disclosure requirements."[265] They were also apparently subject to "off balance sheet" accounting treatment, which made their risks less transparent and enabled banks to offer products that are functionally equivalent to positions that client institutions were not

260. ISDA has only lately has attracted scholarly interest. *See, e.g.*, Braithwaite, *supra* note 13 (discussing ISDA's Master Agreement regime); Gelpern & Gulati, *supra* note 17 (discussing ISDA's dispute resolution system); Scott & Biggins, *supra* note 259 (discussing ISDA's relations with nation states); Huault & Rainelli-Le Montagner, *supra* note 128 (describing ISDA's influence strategies); Glenn Morgan, *Legitimacy in Financial Markets: Credit Default Swaps in the Current Crisis*, 8 SOCIO-ECON. REV. 17, 32–40 (2010) (discussing ISDA's activities following the 2008 crisis); HEATHER MCKEEN-EDWARDS & TONY PORTER, TRANSNATIONAL FINANCIAL ASSOCIATIONS AND THE GOVERNANCE OF GLOBAL FINANCE: ASSEMBLING POWER AND WEALTH 43–46 (2013) (describing ISDA's role in global finance). One of the early studies on ISDA's activities is Sean M. Flanagan, *The Rise of the Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211 (2001) (providing a pro-ISDA perspective to its history and activities).

261. FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 47 (2004) [hereinafter PARTNOY, INFECTIOUS GREED].

262. Scott & Biggins, *supra* note 259, at 323.

263. Flanagan, *supra* note 260, at 246.

264. *See* PARTNOY, INFECTIOUS GREED, *supra* note 261, at 38–45 (describing early swaps and other derivatives transactions).

265. *Id.* at 48.

permitted to take.[266] Besides, as non-exchange transactions, many swaps were customized and therefore highly profitable to the dealers.[267]

It seems that at first the investment banks largely ignored the fact that the new OTC derivatives may have been void under the common law and illegal under the Commodity Exchange Act.[268] But the first source of worries was the Financial Accounting Standards Board (the U.S. accounting self-regulatory body), which in February 1985 started asking difficult questions about the new products.[269] This led, within weeks after the inquiry, to the formation of the *International Swap Dealers' Association*.[270] The name was changed into *International Swaps and Derivatives Association* in 1993,[271] seemingly "in an attempt to show ISDA was more than just a lobbying vehicle for the top swap dealers."[272]

ISDA's principal objectives were "to establish standardized documentation and practices, to lobby against new regulations, and to determine how big the swaps market really was."[273] In the words of one of the leading members, the goal was to "organize before any problems arise",[274] although ISDA's first press release merely stated that it sought to "advance general market practices and to discuss issues of relevance to the financial community."[275] It has been claimed that "everyone involved understood that the primary role would be to lobby against

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266. *Id.* at 45–46 (describing banks' activities and arguments); Partnoy, *Derivatives Regulation*, *supra* note 53, at 426–28 (describing regulatory arbitrage uses of early derivatives). Avoiding regulations was a motivating factor even before the 1980s. *See* Flanagan, *supra* note 260, at 223 ("Some simple swap-like agreements were developed in the late seventies to bypass certain United Kingdom currency restrictions").

267. PARTNOY, INFECTIOUS GREED, *supra* note 261, at 49; Partnoy, *Derivatives Regulation*, *supra* note 53, at 427–28 (noting that customized swaps are more profitable than "plain vanilla" swaps); Flanagan, *supra* note 260, at 234 ("Banks [in the 1980s] received large fees and substantial spreads for arranging interest-rate and currency swaps").

268. Stout, *Legal Origin*, *supra* note 242, at 19; Stout, *Speculators*, *supra* note 241, at 780.

269. PARTNOY, INFECTIOUS GREED, *supra* note 261, at 46.

270. *Id.*

271. Flanagan, *supra* note 260, at 222.

272. PARTNOY, INFECTIOUS GREED, *supra* note 261, at 152.

273. *Id* at 47.

274. John P. Forde, *Big Firms Involved in Rate Swaps Form Dealers Association*, THE BOND BUYER, at 4 (Mar. 8, 1985) (citing Jonathan Berg, a vice president at Bankers Trust).

275. *Id*.

regulation of swaps",[276] although it seems that a parallel motivation was to coordinate the ownership and development of the standard documentation, which the leading swap dealers had developed informally since 1984.[277]

2. A Friend of Courts and Lawyers

The first ISDA Master Agreement related to swaps was published in 1987, and generic OTC derivatives Master Agreements have been published in 1992 and 2002.[278] The importance of the ISDA Master Agreement project extends far beyond copyright protection, because what began as ordinary contract standardization became, over time, something of "an industry-wide constitution."[279] Today, ISDA's "standard form documentation enjoys a near-monopoly in the vast 'over-the-counter' derivatives markets."[280]

ISDA's contractual self-governance project includes an active relationship with the courts through its *amicus curiae* briefs in OTC derivatives litigation.[281] These interventions are fundamental, because they seek to persuade courts of "ISDA's preferences" regarding the interpretation of the standardized documents.[282] Given ISDA's expertise and its role as the originator of the contracting scheme, it is likely to yield significant interpretative power in courts.[283]

Apart from courts, ISDA works closely with leading law firms, having over the years developed a network of cooperating lawyers around the world.[284] The leading example of ISDA's influence among

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276. PARTNOY, INFECTIOUS GREED, *supra* note 261, at 47.

277. *See* Flanagan, *supra* note 260, at 234–38 (describing the standardization project).

278. Braithwaite, *supra* note 13, at 787. On the development of the ISDA Master Agreements, see Flanagan, *supra* note 260, at 243–45.

279. Gelpern & Gulati, *supra* note 17, at 357.

280. Braithwaite, *supra* note 13, at 779.

281. *See* ISDA, *Amicus Briefs*, http://www.isda.org/speeches/amicusbriefs.html (last visited June 2, 2014).

282. Scott & Biggins, *supra* note 259, at 326.

283. *See supra* note 47. To be sure, courts have not always accepted ISDA's proposals. *See* Braithwaite, *supra* note 13, at 799–800 (discussing English cases). However, in these cases the principal reason was that "the contractual language left room for disagreement." *Id.* at 800.

284. *See, e.g.*, Flanagan, *supra* note 260, at 233 ("ISDA has hired law firms around the world to research the potential enforceability of close-out netting in their

lawyers is the Potts opinion, which "was unanimously acknowledged as one of the great successes of the organization."[285] Together with its allies, ISDA skillfully created the appearance of a legal consensus, receiving the support of prestigious law firms, which appeared in the debate without disclosing their close ties to ISDA.[286]

The ISDA-generated legal consensus has been supported by the logic of courts in London and New York, which in resolving international finance disputes are highly sensible to the practical consequences of their decisions, applying "laws or ideas from several different jurisdictions in order to reach a commercially sensible result" and attempting to "make decisions that will facilitate international finance."[287] This decision-making is shaped by what Goode has called *judicial parallelism*,[288] whereby courts are reluctant to break an apparent consensus among leading jurisdictions in matters of international finance.[289] Therefore, creating the appearance of consensus has the power to shape the law itself, because courts are unlikely to challenge it.

Unsurprisingly, the ISDA Master Agreement of 1992 and 2002 propose exclusive jurisdiction to either English or New York courts.[290] These choice-of-law provisions can be sidestepped, but parties are warned that "extreme care should be exercised in doing so since the ISDA master agreement has not been prepared with a view to enforceability under other legal systems."[291] This warning is important, because choice of law and jurisdiction is important for managing legal

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jurisdictions"); *id.* at 235 (describing long-standing cooperation with Cravath, Swaine & Moore); *id.* at 240 (showing how several key ISDA figures came from Cravath). Later, Adam W. Glass of Linklaters has been an active collaborator. *See supra* notes 51, 230.

285. Huault & Rainelli-Le Montagner, *supra* note 128, at 559–60.

286. *See supra* notes 132–135 and accompanying text. Flanagan reveals that "Allen & Overy functions as ISDA's primary European counsel." Flanagan, *supra* note 260, at 233. Schwartz also turns out to be an Allen & Overy Associate. Schwartz, *supra* note 4, at 167.

287. Agasha Mugasha, *International Financial Law: Is the Law Really "International" and Is It "Law" Anyway?*, 26 BANKING & FIN. L. REV. 381, 392 (2011) [hereinafter Mugasha, *International Financial Law*].

288. ROY GOODE, COMMERCIAL LAW IN THE NEXT MILLENNIUM 92 (1998).

289. Mugasha, *International Financial Law*, *supra* note 287, at 443 (citing *Lordsvale Finance Plc v. Bank of Zambia*, 3 All E.R. 156 [1996]).

290. Braithwaite, *supra* note 13, at 789.

291. SCHUYLER K. HENDERSON, HENDERSON ON DERIVATIVES 838 (2010).

risk related to "conflicting views as to the true nature, the contractual obligations, or the consequences of the financial transaction."[292]

3. Lobbying Victories in the 1990s: Widening the Regulatory Exemptions

Cooperation with courts and lawyers was essential to financial deregulation, as "the ISDA Master Agreement project was highly successful in assuring public actors that the OTC derivatives industry was in fact capable of largely self-regulating."[293] However, this obviously was not enough. If the dealers and investment banks were at first dismissive of legal risks, this did not last long, and by the end of the 1980s, they were actively trying to change the rules.[294] Throughout the 1990s a key input for legal reform in financial markets came from the banking industry,[295] and ISDA played a lead role.[296]

The rhetorical keyword was "legal certainty".[297] What this meant was certainty that the regulators would not apply the restrictive rules—especially the exchange-trading requirement of the Commodity Exchange Act ("CEA")—to the new OTC transactions, which clearly had been made in violation of the rules.[298] While there is no doubt about ISDA's professional competence, it has over the years acquired a reputation for its aggressive lobbying methods.[299] These have been described as "both condescending (saying officials couldn't possible understand derivatives) and reassuring (saying Wall Street had everything under control)."[300] According to one testimony from the 1990s, "ISDA came to Washington telling everyone they're stupid. Their message was that everything is okay [in derivatives]—a blanket

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292. Mugasha, *International Financial Law*, *supra* note 287, at 393; *see also id.* at 408–09.

293. Scott & Biggins, *supra* note 259, at 323.

294. Stout, *Legal Origin*, *supra* note 242, at 19; Stout, *Speculators*, *supra* note 241, at 780.

295. Stout, *Legal Origin*, *supra* note 242, at 18–20 (describing banking industry initiatives in the 1990s).

296. *See* Flanagan, *supra* note 260, at 245–46 (highlighting ISDA's growing involvement in politics in the 1990s).

297. *See* Stout, *Legal Origin*, *supra* note 242, at 19.

298. *Id.*

299. *See* PARTNOY, INFECTIOUS GREED, *supra* note 261, at 142 (describing Mark C. Brickell, vice president at J.P. Morgan and ISDA's "top lobbyist" in the 1990s).

300. *Id.*

statement, boom."[301] This rhetoric has been backed up by threats that campaign donations would suffer, as financial firms spend large amounts of money in political contributions and lobbying, and "ISDA's members were major political contributors."[302]

A modest victory was gained in 1989, when the CFTC issued a *safe harbor* policy statement, "declaring that [it] would not attempt to regulate swap transactions."[303] However, this had at least two limitations. One was that the CFTC policy statement listed five criteria for applying the safe harbor, in summary: "(1) individually tailored terms; (2) absence of exchange-style offset; (3) absence of clearing organization or margin system; (4) the transaction is undertaken in conjunction with a line of business; and (5) prohibition against marketing to the public."[304] According to Partnoy, "[f]or many swaps at least one of the criteria—often several—were not satisfied."[305]

The second limitation of the 1989 safe harbor was that it did not change the fundamental rules, because the CFTC had no authority to re-write the rule-book. However, following intense lobbying, Congress in 1992 passed the Futures Trading Practices Act,[306] granting the CFTC authority to exempt derivatives from the application of the CEA, and determining that "federal law now preempted any state laws that made OTC derivatives unenforceable, whether as gambling contracts or otherwise."[307] This was promptly followed by the CFTC in 1993 formally exempting OTC swaps from the ambit of the CEA, as well as from state gambling and antibucketshop laws.[308] However, the 1993

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301. GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 38 (2009) (citing Christopher Whalen).

302. *Id.*

303. Stout, *Legal Origin*, *supra* note 242, at 19; *see also* CFTC, Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989); Partnoy, *Derivatives Regulation*, *supra* note 53, at 435–36 (describing the Policy Statement).

304. Partnoy, *Derivatives Regulation*, *supra* note 53, at 436; *see* CFTC, *supra* note 303, at 30,696–97.

305. Partnoy, *Derivatives Regulation*, *supra* note 53, at 438. For a detailed analysis, see *id.* at 439–42.

306. Pub. L. No. 102-546, 106 Stat. 3590.

307. Stout, *Legal Origin*, *supra* note 242, at 19; *see also* Futures Trading Practices Act, §§ 502(a) (amending 7 U.S.C. § 6), 502(c) (amending 7 U.S.C. § 16(e)(2)(A)).

308. Regulation of Hybrid Instruments, 58 Fed. Reg. 5,581 (Jan. 22, 1993) (codified at 17 C.F.R. pt. 35); *see also* Stout, *Legal Origin*, *supra* note 242, at 19–20; PARTNOY, INFECTIOUS GREED, *supra* note 261, at 147; Partnoy, *Derivatives Regulation*, *supra* note

exemption "did not provide nearly the certainty it could have."[309] In particular, the exempted "swap agreements" did not expressly include credit default swaps,[310] and given that CDSs are financially not swaps at all, there is no reason to presuppose that they would have been covered by the exemption.

4. Managing the Image: Derivatives Scandals

Ironically, the granting of some "legal certainty" to OTC swaps was almost immediately followed by a series of major losses and scandals involving OTC derivatives.[311] While these events are open to a range of interpretations,[312] they certainly caused a political backlash, which had already been brewing for some time.[313] A year earlier, Representative Jim Leach had begun "asking some uncomfortable questions of Mark Brickell and the ISDA lobby."[314] This led to the publication, by House Banking Committee staff, of a 900-page report on derivatives in November 1993, condemning the unregulated market.[315] When the crisis hit the market in 1994, new debates were fuelled, as the Government Accounting Office ("GAO") produced a report highly critical of the lack of derivatives regulation,[316] and Leach introduced a derivatives bill based on his staff report.[317]

53, at 436–37 (describing it and pointing out it "was described as [Wendy] Gramm's 'farewell gift' to the swaps industry.").

309. Partnoy, *Derivatives Regulation*, *supra* note 53, at 437.

310. *See id.* (describing the exemption).

311. *See* Stout, *Legal Origin*, *supra* note 242, at 20 ("Just as a nineteenth century judge might have predicted, the near-immediate result was a series of swapsfueled speculative disasters."); PARTNOY, INFECTIOUS GREED, *supra* note 261, at 112–38 (describing the events leading to the derivatives scandals of 1994); FCIC Report, *supra* note 1, at 46–47 (discussing swaps scandals after 1993).

312. *See* Flanagan, *supra* note 260, at 226–27 (presenting a pro-dealer view of some of the cases).

313. *See* PARTNOY, INFECTIOUS GREED, *supra* note 261, at 147 (describing growing skepticism already in 1992, including a Congress request to the Government Accounting Office to consider the necessity of regulating derivatives).

314. *Id.* Partnoy speculates that one possible reason for Leach's activism was he "did not receive financial support from Wall Street and members of the ISDA." *Id.* at 147–48.

315. *Id.* at 148.

316. *See* GENERAL ACCOUNTING OFFICE, GAO/GGD-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (1994), *available*

ISDA's response was highly effective.[318] Among other things, ISDA skillfully influenced the media, persuading journalists to use the word "securities" instead of "derivatives" when reporting derivatives scandals.[319] Brickell also attacked Leach in the media for resorting to "serious misstatements of fact",[320] claiming for example that Leach's bill would impose a suitability standard "not applied to any other area of finance", when in fact it was similar to the already-existing suitability standards in other areas.[321] He also "complained about the Leach bill's supposed capital standards for swaps, when in fact the bill contained no such provisions."[322]

ISDA was not fighting alone, as it was backed up by high-profile figures including Gerald Corrigan (former head of New York Fed, then at Goldman Sachs) and Wendy Gramm (former CFTC chair, then board member at Enron).[323] In the end, the public lost interest in these complicated issues, and all the legislative initiatives died down; the result was a surprise even to industry members, according to the *Institutional Investor* magazine, which "gave the credit to ISDA".[324]

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at http://archive.gao.gov/t2pbat3/151647.pdf; PARTNOY, INFECTIOUS GREED, *supra* note 261, at 150 (describing the report).

317. *See* PARTNOY, INFECTIOUS GREED, *supra* note 261, at 152. There were also three other bills. *See, e.g.*, TETT, *supra* note 301, at 38.

318. According to TETT, "behind the scenes, Brickell and other ISDA officials furiously leapt into lobbying action, determined to block the bills before Congress. Brickell paid a frenetic series of visits to Republican and Democratic congressmen. He also relentlessly called journalists, trying to persuade them to stop writing about derivatives in such a negative light. He then met regulators around the world, preaching the gospel that the industry was capable of cleaning up its act on its own." TETT, *supra* note 301, at 38.

319. PARTNOY, INFECTIOUS GREED, *supra* note 261, at 151 (providing examples and citations from personal correspondence between ISDA and Byron E. Calame, then-deputy managing editor of the *Wall Street Journal*).

320. *Id*. at 152

321. *Id.*

322. *Id.* According to Partnoy, on July 12, 1994, at hearing on the bill, Leach "lost his patience with Brickell . . ., accusing him of lying about provisions of the derivatives bill." *Id*. (citing Lynn Stevens Hume, *Regulators, Industry Give Differing Views on Bill; Leach Blasts Bank Official for Misstating Provisions*, THE BOND BUYER, at 6 (1994)).

323. *Id.* at 153–54.

324. *Id*. at 154 (citing Michael Peltz, *Congress's Lame Assault on Derivatives*, INSTITUTIONAL INVESTOR, at 65 (1994)); *see also* TETT, *supra* note 301, at 39–40 (describing ISDA's victory).

Another publicity challenge came in 1998, when the massive hedge fund Long Term Capital Management nearly collapsed, threatening the stability of the entire banking sector and leading to an almost-$4 billion bailout.[325] Only weeks before, the CFTC—now headed by derivatives-critical Brooksley Born—had suggested it would reconsider OTC derivatives regulation.[326] However, having learned from the previous crisis, the derivatives industry was well prepared and "besieged Congress with appeals to stop any federal regulatory effort."[327] Now the industry was strongly represented in key government organizations, which reacted the very same day of CFTC's pronouncements to prevent any changes to the rule-book.[328] In fact, new laws were enacted, this time only limiting the powers of CFTC to determine OTC derivatives rules.[329]

5. The Silent Revolution: Commodity Futures Modernization Act of 2000

If the 1990s derivatives debacles did not lead to re-regulation, they made the banking lobby increasingly aware of the precarious status of OTC derivatives. Therefore, in 1999, a Presidential Working Group of high-profile figures in the administration with close ties to the investment banking lobby was formed in order to "modernize" derivatives regulation.[330] The Working Group complained about the

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325. *See* FCIC Report, *supra* note 1, at 57 (discussing the LTCM case); Stout, *Legal Origin*, *supra* note 242, at 20.

326. *See* CFTC, Over-the-Counter Derivatives Concept Release (May 7, 1998), *available at* http://www.cftc.gov/opa/press98/opamntn.htm; Scott & Biggins, *supra* note 259, at 319; Stout, *Legal Origin*, *supra* note 242, at 20 (noting that "[t]his was a dramatic shift in policy, as it implied OTC derivatives might be treated as illegal off-exchange futures.")

327. Stout, *Legal Origin*, *supra* note 242, at 20.

328. *See* U.S. Treasury, Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan and Securities and Exchange Commission Chairman Arthur Levitt (May 7, 1998), *available at* http://www.treasury.gov/press-center/press-releases/Pages/rr2426.aspx; Scott & Biggins, *supra* note 259, at 319 (describing the backlash).

329. Stout, *Legal Origin*, *supra* note 242, at 21; *see also* Stout, *Speculators*, *supra* note 241, at 768.

330. Stout, *Legal Origin*, *supra* note 242, at 21; *see* PRESIDENT'S WORKING GRP. ON FIN. MRKS., OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (Nov. 1999) [hereinafter PWG REPORT], *available at* http://www.ustreas.gov/press/releases/reports/otcact.pdf.

"cloud of legal uncertainty [that] has hung over the OTC derivatives markets in the United States in recent years . . . [and] could discourage innovation and growth of these important markets."[331] Instead of re-examining the need to regulate OTC derivatives, the objective was to guarantee the enforceability of off-exchange derivatives.[332]

This was duly accomplished the following year with the passage of the Commodity Futures Modernization Act of 2000, which drastically expanded the scope of deregulated derivatives markets.[333] As a piece of legislation, it is "long, complex, technical, and difficult to understand," which may explain why its "passage went relatively unnoticed and unremarked by anyone outside the derivatives industry."[334] Yet its significance can hardly be overstated: according to Hazen, "[t]he increased regulation of the securities markets in the wake of the late 1990's corporate governance scandals […] stands in sharp contrast to the massive deregulation of the commodities and non-securities derivatives markets that was ushered in by the Commodity Futures Modernization Act".[335] Moreover, it has been claimed that ISDA was heavily involved in the drafting process.[336]

The CFMA had at least two important consequences. One, it "restricted the capacity of the SEC and CFTC to directly intervene in OTC trading between sophisticated market participants."[337] In terms of the CFTC and the CEA, the CFMA exempted OTC derivatives made between eligible contract participants and subject to individual negotiation.[338] With respect to the SEC, the CFMA ensured that the notion of "securities" would not include any "security-based swap agreement."[339] It also reduced the powers of the SEC to investigate

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331. PWG REPORT, *supra* note 330, at 1.

332. Stout, *Legal Origin*, *supra* note 242, at 21.

333. For a detailed overview of the CFMA, see, for example, JOHNSON & HAZEN, *supra* note 255, § 1.18; Hazen, *supra* note 87, at 388–95.

334. Stout, *Legal Origin*, *supra* note 242, at 21.

335. Hazen, *supra* note 87, at 382.

336. PARTNOY, INFECTIOUS GREED, *supra* note 261, at 295.

337. Scott & Biggins, *supra* note 259, at 320.

338. Stout, *Legal Origin*, *supra* note 242, at 21 (citing CFMA §§ 103, 120 (codified at 7 U.S.C. §§ 2(h), 25(a)(4) (2012)); Sjostrom, *supra* note 41, at 986; Wynkoop, *supra* note 55, at 3100.

339. *See* CFMA § 302(a), § 303(a) (codified at 15 U.S.C. § 77b-1, § 78c-1 (2012)); Sjostrom, *supra* note 41, at 984. A "security-based swap agreement" is a swap "of which a material term is based on the price, yield, value, or volatility of any security . . .

fraud, manipulation or insider trading in security-based swap agreements.[340]

Secondly, the CFMA expanded the notion of *swap agreements*, explicitly mentioning credit default swaps.[341] The CFMA definition of swap agreements is complex, but what makes it interesting is that it departs radically from standard financial definitions of swaps: instead of referring to an exchange of cash-flows, it extends swaps to an agreement that "transfers . . . the financial risk associated with a future change in any . . . value or level [of securities or other financial or economic interests] known as . . . credit default swap."[342] The text is paradoxical, because it defines CDSs in terms of a *pure risk transfer*, but simply calls them swaps. This suggests that the drafters were aware of the awkward status of CDSs as swaps, but they were determined to exploit the fact that OTC swaps had become the least regulated legal category, and few people outside the industry understood them anyway.

Another paradox of the CFMA is that its official objectives included "reduc[ing] systemic risk by enhancing legal certainty."[343] The apparent justification for this claim was that the uncertain enforceability of OTC derivatives might cause disruptions.[344] This reasoning was optimistic in retrospect, as the passage of CFMA was followed by a spectacular growth of OTC derivatives trading—especially of a speculative nature—as anyone could have predicted.[345] Stout has gone so far as to argue that "the [2008] credit crisis was not primarily due to 'innovations' in the markets or the legal system's failure to 'keep pace' with finance. The crisis was caused, first and foremost, by *changes in the law*."[346]

C. THE GLOBAL FINANCIAL CRISIS: THE PARADOXICAL DODD-FRANK

.," so that it is not regulated as a security. *See* Sjostrom, *supra* note 41, at 985; 15 U.S.C. § 78c note (2012).

340. Sjostrom, *supra* note 41, at 985.

341. *See id*. at 984–85 (discussing the definition of "swap agreement" in CFMA).

342. 15 U.S.C. § 78c note (2012).

343. CFMA § 2(6); *see also* PWG REPORT, *supra* note 330, at 6 (noting the same objective).

344. Stout, *Legal Origin*, *supra* note 242, at 22.

345. *See* Stout, *Legal Origin*, *supra* note 242, at 22–29 (describing the developments); Stout, *Speculators*, *supra* note 241, at 772–73 (arguing, in 1999, that enabling speculation would increase systemic risks).

346. Stout, *Legal Origin*, *supra* note 242, at 3.

ACT

The lack of regulation was challenged at least temporarily by the global financial crisis, and in addition to the steps taken by state insurance regulators, bills were introduced at federal level to prohibit uncovered CDSs or all CDS trading.[347] But the industry, led by ISDA, fought back.[348] At first it denied any problems, but soon a cooperative mode was adopted that would prove to be highly effective.[349] Although the Dodd-Frank Act of 2010 takes a step in the direction of more regulation, a closer look reveals a mixed picture with respect to OTC derivatives.[350]

1. New Restrictions

For CDSs, the Dodd-Frank Act increases regulation at least in four ways. Firstly, it abolishes the CFMA prohibition of regulating OTC derivatives by affirming the jurisdiction of CFTC over "swaps" and SEC over "security-based swaps".[351] Secondly, it subjects "security-based

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347. Respectively, H.R. 2454, 111th Cong. § 355(h) (2009) and H.R. 3145, 111th Cong. § 4 (2009); *see* Shadab, *supra* note 4, 425 (describing federal bills). Even the Derivatives Markets Transparency and Accountability Act of 2009 (H.R. 977) initially proposed a ban on uncovered CDSs, but this was subsequently reduced to regulatory authority to prohibit "abusive swaps" and finally abandoned altogether. *See* Saunders, *supra* note 6, at 448 n.151; Ben Moshinsky & Aaron Kirchfeld, *Naked Swaps Crackdown in Europe Rings Hollow Without Washington*, BLOOMBERG (March 11, 2010), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aj9Qo2YqmFKs.

348. Christopher Arup, *The Global Financial Crisis: Learning From Regulatory and Governance Studies*, 32 L. & POL. 363, 371 (2010).

349. *See* HOUSE OF REPRESENTATIVES COMM. ON AGRIC., SER. NO. 111–1, HEARING TO REVIEW DERIVATIVES LEGISLATION 165 (Feb. 3, 2009), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg51698/pdf/CHRG-111hhrg51698.pdf (showing Senator James C. Marshall, GA, getting impatient with ISDA's Robert Pickel for "just stonewalling" and suggesting "that the industry start considering compromises instead of just blowing through all of this").

350. *See* Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 234–42 (2011) (critically discussing the Dodd-Frank Act's approach to CDSs); Stout, *Legal Origin*, *supra* note 242, at 31–36 (likewise, with respect to OTC derivatives generally).

351. Dodd-Frank Act, §§ 722(a)–(b), 762(a); *see* Bloink, *supra* note 215, at 607–08; Eduard H. Cadmus, Note, *An Altered Derivatives Marketplace: Clearing Swaps Under Dodd-Frank*, 17 FORDHAM J. CORP. & FIN. L. 189, 208–09 (2012).

swap dealers" and "major security-based swap participants" to SEC registration.[352] Thirdly, it prohibits federal bailouts of "swaps entities".[353] Fourth, it imposes a clearing requirement for speculative swaps.[354]

There are, however, several reasons why the outcome is far from onerous. For one thing, SEC and CFTC jurisdiction is limited to what is expressly admitted.[355] Similarly, the bailout prohibition—known as the "swap pushout rule"[356]—is watered down in various ways: it does not apply to insured depository institutions,[357] and does not prevent them from establishing affiliates that function as swaps entities.[358] Thus it has been estimated that the "exceptions to the general prohibition threaten to swallow the rule, and the exposure of many financial institutions to CDS risk will continue."[359]

2. Mandatory Clearing and Its Limits

The principal solution offered by Dodd-Frank for the problems of OTC derivatives is the imposition of a mandatory central counterparty clearing requirement for many of these transactions.[360] The principle is the same as in the old Commodity Exchange Act, which required "that speculative commodity futures be traded only on organized exchanges."[361] The objective is to promote transparency and reduce counterparty risks.[362]

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352. Dodd-Frank Act, §§ 731, 764; *see also* Cadmus, *supra* note 351, at 213; Bloink, *supra* note 215, at 609–10. On the definition of swap dealers and major swap participants, see Cadmus, *supra* note 351, at 210.

353. Dodd-Frank Act, § 716; *see* Bloink, *supra* note 215, at 610–12.

354. Dodd-Frank Act, §§ 723(a)(2), 763(a); *see* Bloink, *supra* note 215, at 608–09; Cadmus, *supra* note 351, at 213–14.

355. Dodd-Frank Act, § 712(b).

356. Annette L. Nazareth, *Dodd-Frank Act Finalizes Swap Pushout Rule*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 7, 2010), http://blogs.law.harvard.edu/corpgov/2010/07/07/dodd-frank-act-finalizes-swap-pushout-rule.

357. Dodd-Frank Act, § 716(b)(2)(B).

358. Dodd-Frank Act, § 716(c).

359. Bloink, *supra* note 215, at 611.

360. Dodd-Frank Act, § 723(a)(2) (swaps); § 763(a) (security-based swaps).

361. Stout, *Legal Origin*, *supra* note 242, at 34.

362. Johnson, *supra* note 350, at 234–38. On the details, *see also* Cadmus, *supra* note 351, at 219; Stout, *Legal Origin*, *supra* note 242, at 34.

The question is how much will be achieved. The first concern relates to the exceptions to the clearing requirement. One of them applies when swaps are used by a non-financial entity "to hedge or mitigate commercial risk."[363] Other transactions may also be exempted from clearing, because this is ultimately subject to SEC and CFTC determinations.[364] Some commentators have been worried that the regulators might yield to the enormous pressure of the financial industry.[365] This concern is especially pertinent in relation to customized CDSs, which cannot be cleared so easily.

In fact, several commentators claim that there is an *automatic exemption* for non-standardized CDSs and other derivatives that clearinghouses will not accept for clearing.[366] The legal basis of this affirmation is not entirely clear.[367] But if non-standardized transactions are exempted, there is an enormous regulatory loophole.[368] To be sure, even non-cleared swaps must be reported to a registered swap data

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363. Dodd-Frank Act, §§ 723(a), 763(a); *see also* Stout, *Legal Origin*, *supra* note 242, at 34; Cadmus, *supra* note 351, at 213; Johnson, *supra* note 350, at 239 n.369 (providing details).

364. Dodd-Frank Act, §§ 723(a) (CFTC), 763(a) (SEC); Bloink, *supra* note 215, at 608 (SEC); Cadmus, *supra* note 351, at 214 (CFTC).

365. Stout, *Legal Origin, supra* note 242, at 36.

366. *See* Steven L. Schwarcz, *Identifying and Managing Systemic Risk: An Assessment of Our Progress*, 1 HARV. BUS. L. REV. 94, 101 n.29 (2011), http://www.hblr.org/?p=1412 ("Dodd-Frank includes an exception for derivatives that a clearinghouse will not accept for clearing. Dodd-Frank Act sec. 723(a), § 2(h)(3)."); Johnson, *supra* note 350, at 240 ("The Dodd-Frank Act requires that only standardized credit default swap contracts be cleared through a central counterparty or derivatives clearing organization."); *Regulatory Reform and the Derivatives Market: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry*, 111th Cong. 8, 89 (2009) (statement of Gary Gensler, Chairman, Commodity Futures Trading Commission) ("It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated.").

367. Dodd-Frank Act § 723(a) amends § 2(h)(3)(C) of the Commodity Exchange Act so that the Commission must determine whether and under what conditions, if any, a "swap, or group, category, type, or class of swaps" must be subject to such clearing. *Id.* In making this determination, the crucial question for the Commission is whether the contracts satisfy § 2(h)(2)(D), which provides five factors that the Commission must consider, including trading liquidity. *See id.* Therefore, there is a legal basis for exempting some contracts from the mandatory clearing requirement, but it is not an automatic exemption and is subject to significant prudential judgment. *See id.*

368. Frank Partnoy, *Danger in Wall Street's Shadows*, N.Y. TIMES (May 14, 2009); Johnson, *supra* note 350, at 241.

repository,[369] and SEC and CFTC have powers to investigate "abusive swaps", i.e. transactions seen to be "detrimental to . . . the stability of a financial market . . . or . . . participants in financial markets."[370] If CDSs continue to be widely used by hedge funds and investment banks, these powers of investigation should be exercised.

The second concern is that "the clearinghouse requirement might inadvertently concentrate systemic risk in the clearinghouses themselves."[371] According to one expert, "it is plausible that central clearing would raise systemic risks greatly when another crisis occurred and perhaps even raise the likelihood of a crisis."[372] While it is true that clearinghouses have rarely failed, one should not rely too much on history.[373] Recent decades have witnessed several clearinghouse failures, and there is a danger that complex OTC derivatives would create substantial difficulties, especially if clearinghouses are *forced* to accept them.[374] It has also been argued that the current resolution system is highly vulnerable to systemic risk in derivatives clearinghouses.[375]

3. Preemption of Insurance Regulation

For the present Article, one of the key aspects of Dodd-Frank is that the derivatives industry obtained an exclusion of insurance regulation.[376] This was a surprise, because the original draft did not address the question of CDSs and insurance, and in fact sought to

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369. Dodd Frank Act, §§ 727, 729, 766; Bloink, *supra* note 215, at 608; Cadmus, *supra* note 351, at 214–15.

370. Dodd Frank Act, § 714; Bloink, *supra* note 215, at 608–09.

371. Schwarcz, *supra* note 366, at 101 n.29; *see also* Julia Lees Allen, Note, *Derivatives Clearinghouses and Systemic Risk: A Bankruptcy and Dodd-Frank Analysis*, 64 STAN. L. REV. 1079, 1091–93 (2012); Christopher L. Culp, *OTC-Cleared Derivatives: Benefits, Costs, and Implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act,"* 2 J. APPLIED FIN. 1, 23 (2010).

372. Chester S. Spatt, *Complexity of Regulation*, 3 HARV. BUS. L. REV. 1, 6 (2012), http://www.hblr.org/?p=2299.

373. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the 2011 Financial Markets Conference: Clearinghouses, Financial Stability, and Financial Reform 8 (Apr. 4, 2011) *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20110404a.pdf.

374. Spatt, *supra* note 372, at 6; Culp, *supra* note 371, at 23.

375. *See* Allen, *supra* note 371, at 1093–106.

376. Cadmus, *supra* note 351, at 208.

impose an insurable interest rule on uncovered CDSs.[377] The banking lobby was able not only to block this but also to obtain an express exclusion of insurance law, which was added to the final version of the law seemingly without careful examination.[378] Thus Section 722 (amending the Commodity Exchange Act) states laconically: "A swap—(1) shall not be considered to be insurance; and (2) may not be regulated as an insurance contract under the law of any State."[379] Similarly, Section 767 adds (amending the Securities Exchange Act): "A security-based swap may not be regulated as an insurance contract under any provision of State law."[380]

One might question the applicability of these exclusions to CDSs, given that it is difficult to see how CDSs could be functionally labeled swaps.[381] Therefore the definition of "swaps" in Section 721 has been rendered so broad that it is almost another label for any derivative.[382] It also expressly includes a "transaction commonly known as . . . a credit default swap".[383]

As an ironic consequence of this anti-functionalist approach to classifying financial products, concerns have subsequently been raised that the new rules are creating legal uncertainty to insurers, because such contracts as financial guaranty insurance might come under the regulation of swaps (which insurers are not permitted to trade).[384] This

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377. *See* Saunders, *supra* note 6, at 448 n.151.

378. *See* Letter from Robert Damron, President, and Joseph Morelle, Chairman of the Fin. Services & Inv. Products Comm.Committee, Nat'l Conference of Ins. Legislators, to Barney Frank, Chairman of the U.S. House-Senate Financial Reform Conference Comm.Committee (June 15, 2010) (*available at* http://www.ncoil.org/HomePage/2010/07152010615CDSLetter.pdf.).

379. Dodd-Frank Act, § 722.

380. Dodd-Frank Act, § 767. This statement is strangely found under the heading "State Gaming and Bucket Shop Laws,"suggesting that it was added late in the drafting process.

381. *See supra* Part II.D.3.

382. Stout, *Legal Origin*, *supra* note 242, at 33; *see* Dodd-Frank Act § 721(a)(21); Cadmus, *supra* note 351, at 209–10 (explaining the definition). The amended definitions merely exclude some derivatives as *non-swaps*.

383. Dodd-Frank Act § 721(a)(21). For our purposes, the definition of "security-based swap agreements" in the Securities Exchange Act refers back to this revised definition of swaps: *see* Dodd-Frank Act § 761(a)(6).

384. *See* Houman B. Shadab, *Doesn't Anyone Want to Be a Swap Anymore?* (Nov. 1, 2011), http://lawbitrage.typepad.com/blog/2011/11/doesnt-anyone-want-to-be-a-swap-anymore.html (describing insurance industry concerns).

absurdity is the logical consequence of artificially creating different regulatory regimes for transactions that have exactly the same content,[385] and legal uncertainty can only be avoided by giving strict primacy to form over substance, in contradiction with insurance law tradition.[386]

CONCLUSION

This Article has clarified our legal understanding of CDSs in two principal ways: firstly, in relation to insurance, showing how the principles of insurance law are correctly applied to CDSs, and secondly, in relation to derivatives, explaining how the deregulated space for OTC derivatives was created, consolidated, and expanded to include CDSs.

In relation to insurance law, this Article has firstly pointed out that, contrary to an oft-repeated belief, New York Insurance Law did not define CDSs as non-insurance transactions.[387] It has then explained why the no-intention-to-insure argument is defective both in law and in fact, [388] also demonstrating that "credit default swaps" are not structurally and economically swaps at all.[389] It has also cleared up confusion regarding the notions of insurable interest and loss indemnity, proposing how they should be applied to CDSs.[390]

In order to explain the derivatives-characterization of CDSs, the Article has argued that the financial sector has skillfully exploited the increasingly disparate treatment of functionally similar transactions.[391] On one hand, the restrictive regime of insurance regulation was avoided in subtle ways such as by promoting a private legal opinion (the Potts opinion) to this effect,[392] obtaining favorable responses from regulators

385. *See supra* Part II.D.2.
386. *See supra* Part II.D.1.
387. *See supra* Part I.C.3.
388. *See supra* Part II.D.
389. *See supra* Part II.D.3.
390. *See supra* Parts II.E and II.F.
391. CDSs are at the intersection of securities, derivatives, gambling, and insurance: they have been mostly classified as either derivatives or insurance contracts, but some have defined them as securities. *See supra* note 51 and accompanying text. Still others have called them "gambling" (for example New York State Governor Paterson). *See* Hakim, *supra* note 229. On the increasingly disparate regulation of securities, derivatives, gambling, and insurance, see Hazen, *supra* note 87 (analyzing this issue systematically).
392. *See supra* Parts II.C.1 and III.B.2.

to narrowly formulated questions,[393] and proposing novel definitions or demarcation criteria of insurance.[394] On the other hand, the banking lobby introduced the novel concept of *swap*, which was first used to exploit regulatory exemptions,[395] and later extended to an increasing range of transactions, including CDSs.[396]

The arguments presented here imply several questions for scholars and policymakers. In terms of legal doctrine, the present situation is uncomfortable, as the arguments for the derivatives-based view are based on a misinterpretation of insurance law principles,[397] and buttressed by a misreading of legislation.[398] As it moreover remains unclear on what basis CDSs can be meaningfully described as swaps,[399] this raises the question of whether this terminology was but a trick for avoiding regulation. In consequence, functionally identical transactions may now be insurance, derivatives, or even both.[400] In the U.S., the confusion is only exacerbated by Dodd-Frank Act's preemption of insurance law, which is coupled with an all-encompassing notion of swaps that extends this deregulated category to CDSs on a purely formalistic basis.[401] There is no synthesis or compromise between the different views, which merely seem to co-exist side by side, at best agreeing to disagree.

In terms of financial regulation, the recent reforms are a modest step forward—but very modest indeed, as they are also filled with problems: Firstly, the Dodd-Frank compulsory clearing rule is likely to apply only to some CDSs, leaving others unregulated.[402] Secondly,

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393. *See supra* Part II.H.1 and notes 225–227 and accompanying text.

394. *See supra* note 95 and accompanying text (noting Henderson's use of a non-legal definition); Kimball-Stanley, *supra* note 3, at 262–66 (criticizing the distinctions proposed by Schwartz, and Nirenberg and Hoffman). One might also speculate that the erroneous interpretation of New York Insurance Law, *supra* Part I.C.3, may have been influenced by the desire to liberate CDSs from insurance law. *See supra* notes 65–66. Shadab, Sjostrom and Schwartz are all opposed to the application of insurance regulation to CDSs.

395. *See supra* Parts III.B.1 and III.B.3.

396. *See supra* notes 342 (CFMA) and 383 (Dodd-Frank Act) and accompanying text.

397. *See supra* Part II.

398. *See supra* Part I.C.3.

399. *See supra* Part II.D.3.

400. *See supra* Part II.D.2.

401. *See supra* notes 384–386 and accompanying text.

402. *See supra* notes 363–368 and accompanying text.

there are serious worries regarding the concentration of systemic risks in derivatives clearinghouses, which may sow the seeds of a new crisis.[403] Thirdly, many concerns associated with CDSs remain largely unaddressed.[404] Thus there is an urgent need for continued critical investigation on the real costs and benefits of CDSs and their regulatory options.

403. *See supra* notes 371–375 and accompanying text.
404. *See supra* Parts I.B.2 and II.G.