

BACKGROUND

No. 3076 | NOVEMBER 16, 2015

Fixing the Dodd–Frank Derivatives Mess: Repeal Titles VII and VIII

Norbert J. Michel, PhD

Abstract

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act dramatically altered the regulatory framework for certain derivatives markets. Title VII institutes many inappropriate regulatory remedies because it is based on the false notion that a lack of regulation caused the financial crisis. The core of the Title VII restructuring is commonly referred to as a clearing mandate, where swaps users’ counterparty risks are transferred to a clearing firm. The clearing mandate centralizes risk in a small number of large firms, increases moral hazard, and increases the likelihood of a future financial crisis. Title VIII provides bank-like access to the Federal Reserve for these clearing firms to mitigate the problems caused by Title VII. Thus, Title VIII is essentially an admission that Title VII undermines financial stability. Leaving these changes in place will have harmful consequences on the stability, competitiveness, and effectiveness of financial markets. The problems caused by Titles VII and VIII of Dodd–Frank are typical examples of why the Dodd–Frank Act should be repealed.

“[I]n the popular press and to the average citizen, ‘derivatives,’ much like speculation, has become a dirty word, hindering informed discussion.”

—Roberta Romano, *Maryland Law Review*, 1996

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act was Congress’s response to the 2008 financial crisis.¹ Titles VII and VIII of the act dramatically altered the way certain derivatives markets are regulated. These titles are largely based on the faulty premise that the swaps market contributed to the 2008

KEY POINTS

- Titles VII and VIII of the Dodd–Frank Act have fundamentally altered federal oversight of derivatives markets in ways that create moral hazard, undermine financial stability, and create more “too big to fail” institutions.
- Title VII contributes to these problems primarily via a misguided requirement for swaps to be cleared through a central clearing firm, thus concentrating financial risks that were formerly decentralized.
- Title VIII, in recognition of this new risk, treats these clearing facilities as systemically important financial institutions (SIFIs) and gives them access to Federal Reserve lending, creating more moral hazard and further undermining financial stability.
- Title VIII also gives federal regulators discretionary authority, with essentially no standards, to regulate virtually any financial firm and any aspect of U.S. financial markets. Congress should not have given federal regulators such power.
- Titles VII and VIII of Dodd–Frank are two good examples of why the act should be repealed.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3076>

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

crisis because it was unregulated. This notion is demonstrably false because federal banking regulators have publicly acknowledged that they regulated the bulk of the swaps market before the crisis. Nonetheless, Title VII sets up a new framework whereby federal regulators micromanage the swaps industry—as if regulators can better manage risks than market participants can.

Title VII imposes new clearing, trading, reporting, margining, and business conduct requirements on swap market participants. All of these requirements impose additional costs on swaps users, but the Title VII clearing mandate is particularly troubling. This directive, the central component of the new regime, threatens nonfinancial businesses' safety by making it more costly to hedge commercial business risks. Worse, the clearing mandate is likely to undermine financial stability because it gives rise to larger, less stable central clearinghouses. In particular, the clearing requirement concentrates formerly decentralized financial risks in a small number of large clearing firms.

Title VIII of Dodd–Frank magnifies this financial stability problem by conferring a special status on these clearing companies. These firms, identified as financial market utilities (FMUs), are the Title VIII counterpart to the so-called systemically important financial institutions (SIFIs), which Title I of Dodd–Frank addresses. Title VIII provides these companies with direct access to Federal Reserve lending, creating more moral hazard and further undermining financial stability. Title VIII also gives federal regulators a little-discussed discretionary authority, with practically no standards, that could be used to regulate virtually any sector of U.S. financial markets. Titles VII and VIII are two good examples of why the Dodd–Frank Act should be repealed.

Overview of Derivatives Markets and Swaps

Derivatives securities are essentially contracts between buyers and sellers (commonly referred to as counterparties), but there are many different types of derivatives. Broadly speaking, these (typically) long-lived contracts bind the counterparties to buy or sell some asset at a future date at a certain price. The value of the contract—the derivative itself—is therefore tied to some underlying asset, such as a corporate bond. In general, the counterparties buy and sell these contracts so that they can lower their exposure to uncertain future price movements.² Speculation aside, that is, the primary use of derivatives is to reduce financial risk.

Three of the more common types of derivatives are futures, forwards, and swaps. Futures are derivatives contracts used so commonly that they are standardized financial instruments, a feature that allows them to trade on exchanges, much like stocks.³ The Chicago Mercantile Exchange, for instance, provides a market where counterparties can buy and sell standardized futures contracts on commodities, such as butter, lumber, cattle, foreign currencies, and even stock market indexes. Forwards, on the other hand, are most often specialized contracts between two financial firms or between a financial firm and its customer. Internationally active corporations regularly enter into forward contracts to hedge against losing money on future changes in exchange rates.⁴

Whereas futures contracts typically do not require the physical delivery of an asset at maturity, forward contracts normally do require delivery. Swaps are similar to forward contracts but they require counterparties to make a *series* of future payments, whereas forward contracts require only one future payment. Swap contracts can, therefore, be viewed as a series of forward contracts. The most commonly used swaps are those that hedge against interest rate risk, but market participants use many different types of swap contracts.⁵ His-

1. Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111–203, 2010, <https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf> (accessed March 6, 2015).

2. John Hull, *Options, Futures, and Other Derivatives*, 3rd ed. (Upper Saddle River, NJ: Prentice-Hall, 1997).

3. *Ibid.* Historically, the exchanges have set the rules and procedures for standardization of futures contracts.

4. *Ibid.*, and Roberta Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation,” *Maryland Law Review*, Vol. 55, No. 1 (1996), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2985&context=fss_papers (accessed June 22, 2015).

5. As of June 2013, the International Swaps and Derivatives Association (ISDA) reported that interest rate swaps accounted for more than 80 percent of the over-the-counter (OTC) derivatives market. See ISDA, “The Value of Derivatives ISDA’s–2014 Brochure,” <http://www2.isda.org/about-isda> (accessed June 22, 2015).

torically, most swaps have been negotiated directly (bilaterally) between large banks and other institutional investors—such as insurance companies, pension funds, and mutual funds—on the over-the-counter (OTC) market rather than purchased on exchanges.⁶

Exchanges Versus OTC Markets. Standardized financial instruments typically trade on exchanges, whereas nonstandard financial products, such as highly customized credit default swaps (CDSs), tend to trade in OTC markets. In general, the idiosyncratic nature of customized financial products reduces the number of interested buyers and sellers, thus making the instruments poor candidates for trading on an exchange. Many OTC derivatives are tailored for specific firms' hedging strategies, so relatively few parties are interested in buying such instruments. Buyers and sellers of standardized exchange-traded derivatives, on the other hand, generally have no trouble finding many others with whom they can execute trades. Furthermore, all market participants can easily identify the prices at which exchange-traded securities are being sold, and easily use that information to determine whether they feel the price is too high or, alternatively, represents a bargain.⁷

This price transparency exists before and after all trades, and prices can reflect all sorts of information available to market participants—even information that turns out to be incorrect. On the other hand, many highly customized OTC derivatives will always be unlikely to trade in great volumes and, therefore, will not be priced as transparently

as many exchange-traded products. The trading venue would not, however, preclude regulators from requiring any needed information about the underlying contracts. Historically, as particular financial products become more widespread, they become more standardized and their trading migrates to exchanges.⁸ This natural process may or may not develop for certain products, but whether a derivative trades on an exchange or in the OTC market by itself says very little about the risks the contract poses to counterparties.

Risk and the OTC Derivatives Market. Many commentators have pointed to the enormous *notional* size of the OTC derivatives markets—approximately \$700 trillion—as an ominous indicator of the systemic risk that derivatives create.⁹ This statistic is misleading for several reasons. To begin, the notional size of the market obscures the fact that derivatives, such as CDSs, improve firms' ability to diversify and reduce their risks.¹⁰ In fact, derivatives securities, such as OTC market CDSs, do not create any new risk. Instead, a CDS merely provides protection to end users by shifting *existing* risks to other firms that are more willing and able to risk their capital. The notional amount of a derivatives contract does not accurately reflect even the amount of capital at risk.

The notional size of an OTC contract merely represents the maximum amount to which a counterparty could be exposed.¹¹ For example, JP Morgan could sell a CDS contract, based on a notional value of \$10 million, to a jet fuel supplier that wants to protect itself should United Airlines be unable to pay its monthly

-
6. In the U.S., swaps markets are heavily concentrated among commercial banks, perhaps the largest institutional users. For instance, the largest five banks account for roughly 95 percent of all swaps among the largest 25 commercial banks. Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012," Table 1, Quarter 3, 2012, <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq312.pdf> (accessed October 7, 2015). Similar concentration appears globally; see Darrell Duffie, "Futurization of Swaps," Bloomberg Government, January 28, 2013, p. 2, http://www.darrellduffie.com/uploads/policy/DuffieBGOV_FuturizationOfSwaps.pdf (accessed July 28, 2015).
 7. Randall Dodd, "Markets: Exchange or Over-the-Counter," International Monetary Fund, March 28, 2012, <http://www.imf.org/external/pubs/ft/fandd/basics/markets.htm> (accessed July 28, 2015).
 8. Duffie, "Futurization of Swaps." For more on the OTC markets, see Darrell Duffie, *Dark Markets: Asset Pricing and Information in Over-the-Counter Markets* (Princeton, NJ: Princeton University Press, 2012), pp. 1–9.
 9. ISDA, "The Value of Derivatives—ISDA's 2014 Brochure."
 10. Contrary to popular belief, not only did derivatives fail to play the principal role in Lehman's bankruptcy, but Lehman's main U.S. derivatives trading entity, Lehman Brothers Special Financing, added more value to the bankruptcy than other Lehman subsidiaries. See Kimberly Summe, "Misconceptions About Lehman Brothers' Bankruptcy and the Role Derivatives Played," *Stanford Law Review Online*, Vol. 64, No. 16 (November 28, 2011), pp. 16–21, <http://www.stanfordlawreview.org/online/misconceptions-about-lehman-brothers-bankruptcy> (accessed September 6, 2015).
 11. Nicholas Vause, "Counterparty Risk and Contract Volumes in the Credit Default Swap Market," *BIS Quarterly Review*, December 2010, p. 61, http://www.bis.org/publ/qtrpdf/r_qt1012g.pdf (accessed September 7, 2015).

fuel bills.¹² The fuel company would then pay a periodic fee—a percentage of the notional amount—to JP Morgan for the length of the CDS contract. The contract would spell out various default scenarios and obligations, and JP Morgan would be obligated to pay some amount to the fuel supplier if United could not pay its bills. Depending on the nature of the default conditions in the contract, JP Morgan would most likely have to pay less than the \$10 million notional amount on which the CDS is based.

Moreover, firms that sell CDS contracts typically protect their own financial exposure by purchasing separate CDS contracts. JP Morgan, for instance, can buy a CDS contract to protect itself against having to pay the jet fuel supplier, as can the firm that sells this new CDS to JP Morgan, and so on. But the real risk remains whether United can pay its bills. The CDS merely transfers the risk from the jet-fuel supplier to firms willing to risk their capital. In this sense, CDS could not have caused the 2008 financial crisis—only the underlying risk to which the CDS was tied could have caused the crisis. While instructive at some level, the notional amount does not accurately reflect this underlying risk nor the amount of that risk to which the counterparties are exposed.

A better measure of the risk that OTC-derivative counterparties take on is the amount of *credit risk* they face. Credit risk, in turn, is the risk that a counterparty may be unable to make the payments it agreed to in the original contract. The Bank for International Settlements (BIS) estimates total credit risk in the OTC derivatives market with a measure called *gross market value*. In 2011 the BIS reported a gross mar-

ket value of \$19 trillion based on a notional amount of more than \$700 trillion.¹³ Even this measure, however, fails to account for *netting* among counterparties as well as *collateral*, both of which further reduce counterparties' exposure on derivatives contracts.

The process of netting essentially offsets a counterparty's gains and losses so that OTC counterparties cannot simultaneously default on one contract while accepting payment on another—the *net* difference has to be paid (or received).¹⁴ This practice is standard in the International Swaps and Derivatives Association (ISDA) Master Agreement, and it binds a defaulting counterparty to offset defaulting (negatively valued) contracts with non-defaulting (positively valued) contracts.¹⁵ Many of the large institutional investors in the OTC derivatives market have multiple contracts with each other, so applying netting to the gross market value in the OTC market reduces aggregate credit exposure even further.

In 2013, the ISDA estimated that netting reduced credit exposure in OTC derivatives to less than \$4 trillion, a large amount, but far less than \$700 trillion.¹⁶ Similarly, the Office of the Comptroller of the Currency estimates that U.S. commercial banks and savings associations netted more than 90 percent of their derivatives exposure between 2009 and 2012.¹⁷ Credit risk on OTC derivatives is even further reduced by the collateral (margin) requirements commonly negotiated between the counterparties.

As of June 2013, the ISDA estimated that accounting for both netting and collateral reduced the credit exposure in OTC derivatives to \$1 trillion.¹⁸ This lower amount represents less than 0.5 percent of

12. Most such CDS contracts are written on a firm's obligations, such as a notional amount of its corporate bonds. See Andrew Chisholm, *Derivatives Demystified: A Step-by-Step Guide to Forwards, Futures, Swaps, and Options*, 2nd ed. (United Kingdom: John Wiley & Sons, 2010), pp. 69–82.

13. Bank for International Settlements, "OTC Derivatives Market Activity in the First Half of 2011," Monetary and Economic Department, November 2011, p. 12, http://www.bis.org/publ/otc_hy1111.pdf (accessed June 22, 2015). Accurate aggregate data for the CDS market, a subset of OTC derivatives, is difficult to obtain. Experts have pointed out, for instance, that the gross notional CDS outstanding reported by the ISDA (\$55 trillion in 2008) appears to include a high degree of double counting. See Richard Flavell, *Swaps and Other Derivatives*, 2nd ed. (United Kingdom: John Wiley and Sons, 2010), p. 84.

14. Darryll Hendricks, "Netting Agreements and the Credit Exposure of OTC Derivatives Portfolios," Federal Reserve Bank of New York *Quarterly Review*, Spring 1994, http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n1article2.pdf (accessed June 22, 2015).

15. Participants in the OTC derivatives markets have long relied on their private trade association known as the International Swaps and Derivatives Association (ISDA). The ISDA Master Agreement is the contract under which virtually all OTC derivative transactions take place. See Geoff Chaplin, *Credit Derivatives: Trading, Investing, and Risk Management*, 2nd ed. (United Kingdom: John Wiley and Sons, 2010), pp. 60–61.

16. ISDA, "The Value of Derivatives—ISDA's 2014 Brochure." See also David Mengle, "The Importance of Close-Out Netting," ISDA *Research Notes* No. 1, 2010, <http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf> (accessed June 22, 2015).

17. See *Ibid.*, and Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities Third Quarter 2012," Graph 5B.

18. ISDA, "The Value of Derivatives—ISDA's 2014 Brochure."

the notional amount outstanding, and the exposure is roughly consistent with data from both 2011 and 2012 as well. It is also true that some of these individual measures, even after accounting for netting and collateral, can fail to provide a complete picture of system-wide risk because some OTC derivatives participants rely on a process called clearing.

Clearing and Central Counter Parties in the OTC Market. Prior to the 2010 Dodd–Frank Act, a relatively small portion of OTC derivatives market participants relied on central counterparties (CCPs) to reduce their credit risk through a process called central clearing.¹⁹ Compared to separately (bilaterally) negotiated contracts, the CCP clearing process tends to provide more uniform collateral and netting rules, as well as additional protections for the original counterparties. Through this clearing process, CCPs assume the risks of counterparties to derivatives contracts. As a result, the original buyer of a derivatives contract can ignore whether the original seller will uphold its end of the contract.

In return, the CCP requires both parties to post collateral (margin) when they submit a contract for clearing, as well as to provide additional collateral (variation margin) as market conditions change. Typically, a CCP also requires its members to contribute to a guarantee fund to cover losses that exceed the collateral (and other assets), thus mutualizing CCP members' default losses.²⁰ Because all original counterparties to derivatives contracts end up with the same counterparty—the CCP that clears their original contract—the underlying risks of cleared derivatives end up with the CCP.

Some derivatives, such as futures contracts, are more readily amenable to clearing because their standardization enhances transparency and liquidity. These factors contribute to a robust secondary market on *futures* exchanges where market participants regularly offset their risks through various hedging strategies with widely available standardized contracts. More complex, customized swaps, however, typically have not been centrally cleared because they do not offer the same advantages. Many of the derivatives used by the failed American International Group (AIG), for example, were too specialized for clearing.²¹

Still, even without central clearing, bilateral agreements offer counterparties their own advantages, such as the ability to better tailor contracts to specific risks. Furthermore, these counterparties have regularly managed their risk exposure by bilaterally negotiating their own netting, collateral, and other credit enhancement agreements.²² Even though central clearing is not appropriate for all derivatives, a clearing mandate for swaps is a central component of the new regulatory framework in Dodd–Frank Title VII.

Dodd–Frank Title VII

Title VII of Dodd–Frank creates a far-reaching new regulatory framework for the OTC swaps market, principally through amending the Commodity Exchange Act and the Securities Exchange Act of 1934.²³ The stated main goals of Title VII are to “reduce risk, increase transparency, and promote market integrity within the financial system.”²⁴

-
19. Chaplin, *Credit Derivatives: Trading, Investing, and Risk Management*, pp. 350–352. Credit risk is commonly referred to as *counterparty performance risk*; see Craig Pirrong, “The Economics of Central Clearing: Theory and Practice,” ISDA *Discussion Papers Series* No. 1, May 2011, <http://www2.isda.org/news/isda-publishes-the-economics-of-central-clearing-theory-and-practice-a-discussion-paper-on-clearing-issues> (accessed June 22, 2015).
 20. John W. McPartland, “Clearing and Settlement of Exchange Traded Derivatives,” Federal Reserve Bank of Chicago, *Chicago Fed Letter* No. 267, October 2009, <https://www.chicagofed.org/publications/chicago-fed-letter/2009/october-267> (accessed February 3, 2015), and Pirrong, “The Economics of Central Clearing: Theory and Practice.”
 21. Robert McDonald and Anna Paulson, “AIG in Hindsight,” *The Journal of Economic Perspectives*, Vol. 29, No. 2 (Spring 2015), pp. 81–105, http://www.jstor.org/stable/24292124?seq=1#page_scan_tab_contents (accessed September 29, 2015). Also see Darrel Duffie, “Replumbing Our Financial System: Uneven Progress,” *International Journal of Central Banking* (January 2013), <http://www.ijcb.org/journal/ijcb13q0a12.pdf> (accessed June 22, 2015).
 22. Christopher L. Culp, “OTC-Cleared Derivatives: Benefits, Costs, and Implications of the ‘Dodd–Frank Wall Street Reform and Consumer Protection Act,’” *Journal of Applied Finance*, No. 2 (2010), pp. 1–27, <http://www.rmcsinc.com/articles/OTCCleared.pdf> (accessed September 20, 2015).
 23. 7 U.S. Code § 1 and 15 U.S. Code 78a, respectively. Separately, Title XVI of Dodd–Frank addresses the tax treatment of certain derivatives. These issues are beyond the scope of this *Background*, but Title XVI could remain in place without threatening financial stability.
 24. “Commodity Futures Trading Commission, Registration of Swap Dealers and Major Swap Participants,” *Federal Register*, Vol. 77, No. 12, January 19, 2012, p. 2613, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-792a.pdf> (accessed June 22, 2015).

It fails to achieve these goals largely because it is based on the demonstrably false notion that the swaps market contributed to the 2008 crisis because it was unregulated. (See Appendix A.) Furthermore, Title VII incorrectly assumes that regulators can better manage risks in derivatives markets, and more accurately price risks, than market participants themselves.

Title VII splits oversight in the OTC swaps markets between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), such that the CFTC regulates *swaps*, while the SEC regulates *securities-based swaps*.²⁵ Although there are many distinct details across the two regulatory agencies' implementation of Title VII, the general principles are the same, and the bulk of swap market regulations fall under the CFTC's jurisdiction. Title VII left many key issues to be settled during the regulatory rule-making process, so it has given regulatory agencies considerable new discretionary authority. Thus far, the CFTC and the SEC have issued thousands of pages of rules and regulations, with many more regulations to come.²⁶

The Title VII framework is centered on a counterproductive clearing mandate. This directive requires swaps to be cleared through a registered derivatives-clearing organization (DCO) *if* the CFTC determines the swap has to be cleared. The new regulatory regime also requires cleared swaps to be executed on a designated contract market (DCM) or a newly created entity known as a swap execution facility (SEF), unless no DCM or SEF has made the particular swap in question available for trade. Additionally, swap agreements must now be reported to either a

swap data repository (SDR) or the CFTC, a feature that requires a great deal of additional record keeping and compliance. The Title VII framework also includes extensive new margin and position limit (the maximum number of contracts allowed on one underlying security) requirements.

Collectively, these changes have ensnared commercial end users in a mass of regulatory compliance even though their use of swaps had nothing to do with the 2008 financial crisis. End users include farmers and agricultural businesses, as well as other participants in physical commodities markets. The main characteristic of an end user is someone who produces, processes, and sells physical products and also uses swaps to hedge commercial risk. Aside from any specific requirements in Title VII that raise end users' cost of doing business, it is likely that regulators' newfound discretion will restrict end users' ability to hedge commercial risk in the future.²⁷ Title VII wrongly assumes that regulators can design the perfect OTC market and then micro-manage it to eliminate systemic risk.

Swap Dealers, Major Swap Participants, and Eligible Contract Participants. Title VII tries to specify exactly to whom the new regulatory framework will apply. The general idea is to require firms with relatively large swaps positions—other than end users—to adhere to the new regulations. The main entities directly subject to Title VII's new regulatory framework are known as *swap dealers*, *major swap participants*, and *eligible contract participants*.²⁸ Title VII also stipulates that depository institutions are *not* to be considered swap dealers simply for engaging in the practice of offering swaps to their customers in connection with a loan they

-
25. In general, the key difference is on which item the derivative instrument is based. For instance, a swap based on a particular interest rate would be classified as a swap, whereas a swap based on the value of a securities index would be a securities-based swap. Often, regulators synonymously refer to these financial products as Title VII instruments.
26. Title VII requires the CFTC and the SEC to consult with each other, as well as any prudential regulators affected, before issuing new rules for their respective segments of the market. Section 712, 15 U.S. Code § 8302. The prudential regulator could be any of the following: the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, or the Federal Housing Finance Agency. See Section 721(a)(39), 7 U.S. Code § 1a (39). The agencies are also required to issue joint rules, in consultation with the Fed, for *mixed swaps*, those that combine certain characteristics of swaps, and securities-based swaps. See 7 U.S. Code 1a(47)(D). Title VII empowers the Financial Stability Oversight Council (FSOC) to resolve any rulemaking disputes. See Section 712(d)(3), 15 U.S. Code § 8302(d)(3).
27. See, for instance, Gregg Doud, "Position Limits for Derivatives, RIN 3038-AD99," Commodity Markets Council, February 10, 2014, <http://www.commoditymktcs.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf> (accessed July 29, 2015).
28. Regarding securities-based swaps, Title VII defines the terms *security-based swap dealer* and *major security-based swap participant*. Eligible contract participant was a pre-Dodd-Frank term but Title VII altered the definition.

have made.²⁹ Title VII defines a swap dealer as any entity that:

- (i) holds itself out as a dealer in swaps;
- (ii) makes a market in swaps;
- (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

The swap dealer definition also excludes entities that enter into a swap agreement on their own account but not as part of their regular business, as well as dealers that engage in a de minimis (minimal) amount of swap dealing. The de minimis is currently capped at \$8 billion of swaps activity over the previous 12 months. However, at the end of a (yet to be determined) phase-in period, the cap is set to decrease to \$3 billion, and the CFTC can change this amount.³⁰ Commodities end users have testified to Congress that these arbitrary amounts will eventually result in end users being defined and regulated as swap dealers.³¹

Dodd–Frank introduced the term *major swap participant* as a way to regulate non-dealers who use large amounts of swap contracts. The definition is designed to include anyone whose outstanding swaps could have “serious adverse effects” on U.S. financial stability.³² Title VII defines a major swap participant as any entity that is not a swap dealer but “maintains a *substantial position* in swaps for any of the *major swap categories* as determined by the Commission.” Regulators issued a joint rule which states that an entity is deemed to have a *substantial position* in a major swap category if it has a daily average current uncollateralized exposure in a calendar quarter of at least \$1 billion (\$3 billion in the case of rate swaps).³³

Title VII amends the definition of *eligible contract participant* (ECP) to include the terms swap dealers and major swap participants, as well as their securities-based counterparts, because these entities “are likely to be among the most active and largest users of swaps and security-based swaps.”³⁴ While there are many details unique to each category, swap dealers, major swap participants, and eligible contract participants are all now subject to the same new regulatory framework. Under the new regime, swap dealers have the highest level of obligation, followed by major swap participants and ECPs, respectively.

Implementation of these rules has caused a great deal of confusion, particularly for end users who

29. Section 721(a)(49)(A), 7 U.S. Code 1a(49)(A). Section 716 instituted a provision known as the “swaps push out rule,” whereby banks were forced to choose between eliminating their swaps business or losing access to FDIC-insured deposits and the Fed discount window. However, in December 2014, Congress largely revoked this provision. See Norbert Michel, “CRomnibus Swaps Rhetoric for Reality,” *Forbes*, December 22, 2014, <http://www.forbes.com/sites/norbertmichel/2014/12/22/cromnibus-swaps-rhetoric-for-reality/> (accessed October 9, 2015).

30. “CFTC and SEC: Final Rule,” *Federal Register*, Vol. 77, No. 156, August 13, 2012, and “CFTC and SEC: Further Definition of ‘Swap Dealer,’ ‘Security-Based Swap Dealer,’ ‘Major Swap Participant,’ ‘Major Security-Based Swap Participant,’ and ‘Eligible Contract Participant,’” Joint Final Rule; Joint Interim Final Rule; Interpretations,” *Federal Register*, Vol. 77, No. 100, May 23, 2012, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf> (accessed October 9, 2015).

31. Testimony of Lance Kotschwar, on behalf of the Commodity Markets Council, General Farm Commodities and Risk Management Subcommittee, Committee on Agriculture, July 24, 2013, <http://docs.house.gov/meetings/AG/AG16/20130724/101181/HMTG-113-AG16-20130724-SD003.pdf> (accessed September 26, 2015).

32. Section 721(a)(33), 7 U.S. Code 1a(33). The definition does include certain exclusions, such as for hedging commercial risks.

33. The rule does allow an entity to calculate its current uncollateralized exposure by accounting for netting agreements on a counterparty-by-counterparty basis. See “CFTC and SEC Joint Final Rule; Joint Interim Final Rule; Interpretations,” *Federal Register*, Vol. 77, No. 100, May 23, 2012, p. 30664. The rule also provides further detail on many related issues. For instance, an entity can be deemed to have a *substantial position* if its current uncollateralized exposure plus *potential future exposure* is \$2 billion (\$6 billion in the case of rate swaps). (See p. 30671.) The rules do not, however, specify precise guidelines for measuring the value of collateral or potential future exposure. (See pp. 30661–30697.) The four major swap categories are *rate swaps* (including both interest rate and foreign exchange swaps), *credit swaps*, *equity swaps*, and *other commodity swaps*, and the two major categories for securities-based swaps are debt-security-based swaps and other security-based swaps. (See pp. 30662–30663.)

34. “CFTC and SEC Joint Final Rule; Joint Interim Final Rule; Interpretations,” *Federal Register*, p. 30655. There are many other details surrounding the ECP definition, including explicit prohibitions of certain foreign-exchange-related swaps activity from the ECP classification. (See pp. 30646–30661.)

fear costly new regulations. Rather than use swaps to hedge their risks and deal with increased regulatory costs, end users will ultimately have to choose between using futures markets and forgoing the underlying economic activity they normally undertake. That is, rather than engaging in a customized contract to hedge their risk, end users could simply decide to forgo the underlying activity that generates their business risk.

Trading Venue Requirement. Certain swap market participants are now subject to, among other things, trading venue requirements. For instance, Title VII generally requires *cleared* swaps to be executed on an exchange or an SEF, an exchange-like facility created by Dodd–Frank.³⁵ Title VII also makes it illegal for any person other than an ECP to enter into a swap unless that swap is “on, or subject to the rules of, a board of trade designated as a contract market” under section 5 of the Commodity Exchange Act (CEA), the law that codifies the CFTC’s jurisdiction.³⁶ A *board of trade designated as a contract market*, also known as a designated contract market, is an exchange that the CFTC has designated for trading futures or options under the CEA.³⁷

Thus, Title VII tries to speed up the natural migration of customized financial products onto exchanges. This requirement is based on the premise that exchanges provide more liquid and transparent markets, but that premise is a post hoc fallacy: Exchange trades are more liquid and transparent than OTC trades, but not because they are taking place on exchanges. Many OTC swaps are thinly traded precisely because they are uniquely tailored to specific users’ needs. Forcing these swaps to trade on an exchange is unlikely to produce the “better” pricing that regulators (and apparently some institutional investors) seek.

Any thinly traded financial instrument is susceptible to greater price volatility from any given trade.

The pre-trade transparency that exchange trades require makes it easy for other traders to “see” how the market is unfolding and make their own trades in ways that greatly impact the price of thinly traded instruments. Knowing this problem exists, anyone contemplating offering a swap for sale would either avoid the contract altogether or raise the price to compensate for the additional price risk. In any case, forcing the trade onto an exchange by itself does nothing to lower systemic risk, or to increase the kind of transparency that regulators could use to understand the details of OTC swaps contracts.

Title VII Clearing Mandate. The clearing mandate is the main element of the Title VII regulatory framework. In general, swaps must now be cleared through a registered clearinghouse that serves as a central counterparty (CCP). Central clearing is a major change in the swaps market because prior to the 2010 Dodd–Frank Act only a small portion of swaps were centrally cleared.³⁸ Title VII provides several exceptions to the clearing mandate, and also gives regulators a great deal of discretion to decide (on an ongoing basis) which swaps will be cleared.³⁹

In one sense this type of rule is worse than a blanket mandate because the process is more susceptible to regulatory capture and failure, and also creates additional uncertainty among market participants. Regardless, the clearing mandate is misguided and likely to undermine financial stability. The Title VII clearing requirement states that:

It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization that is registered under this Act or a derivatives clearing organization that is exempt from registration under this Act *if the swap is required to be cleared*.⁴⁰ (Emphasis added.)

35. 723(a)(8), 7 U.S. Code 2(h)(8).

36. 723(a)(2), 7 U.S. Code 2(e).

37. See U.S. Commodity Futures Trading Commission, “A Guide to the Language of the Futures Industry,” http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_co#contractmarket (accessed July 29, 2015).

38. The Chicago Mercantile Exchange (CME), for example, cleared bilateral transactions through an entity called ClearPort. See, for instance, Hal Weitzman, “ClearPort Is a Central Part of CME’s Strategy,” *Financial Times*, October 20, 2009.

39. Title VII also mandates that all cleared swaps have to be traded on an exchange, either a DCM or a swap execution facility (SEF) under section 5 of the CEA, but exchange trading and clearing are separate functions. See Section 723(a)(3), 7 U.S. Code 2(h)(8).

40. Section 723(a)(3), 7 U.S. Code 2(h). Also, 7 U.S. Code § 1a(15) defines a derivatives clearing organization (DCO) as “a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that” meets several conditions, all of which relate to enabling counterparties to execute (for instance, settle, net, clear) their agreements.

Title VII allows the CFTC to initiate a review of whether a swap should be cleared, and it allows the CFTC to rely on industry practice to determine whether a swap should be cleared.⁴¹ Title VII states that:

A derivatives clearing organization shall submit to the Commission each swap, or any group, category, type, or class of swaps *that it plans to accept for clearing*.⁴² (Emphasis added.)

Title VII also provides several exceptions to the clearing requirement, including what is commonly referred to as the *end-user exception*.⁴³

The end-user exception applies if one of the swap counterparties (1) is not a financial entity; (2) uses swaps to hedge commercial risk; and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.⁴⁴ The CFTC (using its Title VII authority) also promulgated rules that exempted certain small banks, saving associations, farm credit system institutions, and credit unions from the definition of *financial entity*, and that provided a clearing exemption for swaps between certain affiliated entities.⁴⁵ On an ongoing basis, Title VII adds regulatory uncertainty to a highly dynamic market because it provides regulators with so much discretion for determining which swaps must be cleared.

Title VII requires the CFTC to consider five subjective factors when determining whether previously un-

cleared swaps will have to be cleared. These factors include the impact that clearing will have on systemic risk, as well as “the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.”⁴⁶ As previously discussed, notional exposures do not provide a complete picture of swaps’ risk, and trading illiquidity and lack of robust pricing data are inherent features of customized OTC financial products. These factors should make highly specialized swaps likely to remain un-cleared, but there is no reason to have these rules unless the intent is for regulators to force more swaps into CCPs.⁴⁷

In much the same way that the trading requirement is misguided, the drafters of Dodd–Frank assumed that the effective central clearing that already existed in derivatives markets could be extended via legislation. As discussed previously, while it is true that central clearing has previously been beneficial for some derivatives users, it does not follow that all swaps should be centrally cleared. In fact, forcing too many customized swaps into CCPs—the most likely result of the clearing mandate—unambiguously concentrates financial risk in a small number of large clearing firms.⁴⁸

This increased concentration compounds the fact that central clearing can increase systemic risk in a number of ways. For example, concerns over a CCP’s solvency could lead market participants to “run” from their CCP in an attempt to save their collateral.⁴⁹ The resulting run on the CCP could cause

41. Section 723(a)(3), 7 U.S. Code 2(h)(2).

42. Section 723(a)(3), 7 U.S. Code 2(h)(2)(B)(i). Also see “Commodity Futures Trading Commission, Process for Review of Swaps for Mandatory Clearing: Final Rule,” *Federal Register*, Vol. 76, No. 143, July 26, 2011, p. 44473, <http://www.gpo.gov/fdsys/pkg/FR-2011-07-26/pdf/2011-18663.pdf> (accessed June 25, 2015).

43. “Commodity Futures Trading Commission, End-User Exception to the Clearing Requirement for Swaps: Final Rule,” *Federal Register*, Vol. 77, No. 139, 17 CFR Part 39, July 19, 2012, <http://www.gpo.gov/fdsys/pkg/FR-2012-07-19/pdf/2012-17291.pdf> (accessed July 28, 2015).

44. Section 723(a)(3), 7 U.S. Code § 2(h)(7).

45. See CFTC, “Clearing Requirement Determination Under Section 2(h) of the CEA: Final Rule,” *Federal Register*, 17 CFR Parts 39 and 50, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister112812.pdf> (accessed June 30, 2015).

46. Section 723(a)(3)(2)(D)(ii), 7 U.S. Code 2(h)(2)(D)(ii).

47. In December 2012, the CFTC determined that swaps in two classes of CDS and four classes of interest rate swaps would have to be cleared to meet the Title VII requirements. The type of controversial CDS that AIG used prior to the crisis was not among those listed for clearing. “Commodity Futures Trading Commission, Clearing Requirement Determination Under Section 2(h) of the CEA: Final Rule,” *Federal Register*, Vol. 77, No. 240, December 2012, p. 74287.

48. Robert McDonald and Anna Paulson, “AIG in Hindsight,” *The Journal of Economic Perspectives* (2015).

49. Regulatory concerns over lowering systemic risk through clearing date, at least, to the early 1990s when the Bank for International Settlements published a report analyzing what it termed “centralized” clearing systems. Sheila Bair, “Regulatory Issues Presented by the Growth of OTC Derivatives: Why Off-Exchange Is No Longer Off-Limits,” in *The Handbook of Derivatives and Synthetics*, ed. by Robert Klein and Jess Lederman (Chicago, IL: Probus Publishing, 1994), p. 709.

a liquidity shock in much the same way a bank run could prevent a bank from meeting its obligations to depositors.⁵⁰ The following list summarizes some of the ways that clearing at CCPs can increase systemic risk.⁵¹

- **Increased moral hazard.** CCPs mutualize losses, thus providing an incentive for individual members to take greater risks. In other words, all else being equal, CCP members would be more likely to clear riskier derivatives with a CCP than to retain the original counterparty to such a contract.
- **Increased interconnections.** CCPs are large, interconnected firms that are integral to the operation of financial markets. One expert referred to clearing as the “mother of all interconnections” because virtually all large financial institutions funnel the bulk of their derivatives trading through the same few CCPs, and virtually all CCPs have many of the same members. Thus CCPs provide one of the few examples of how large financial firms are directly interconnected, and how the failure of one clearing member can transmit financial stress to other clearing members.
- **Exacerbate liquidity problems.** Most large financial institutions funnel their derivatives trading through the same few CCPs, and virtually all CCPs have many of the same members. Because CCPs are so interconnected, liquidity problems at any one CCP are likely to transmit to other CCPs. Additionally, any system-wide crisis that impacts a large group of firms is likely to spread to multiple CCPs. Regardless of the source of the financial stress, if a CCP faces liquidity strains, its members can face liquidity shortfalls that trigger a cascade of failures beyond the CCP, transmitting

liquidity risk more broadly to a wider set of (inter-connected) market participants.

- **Deny resources to other creditors.** CCPs require margin and collateral which, by definition, represent financial resources that can no longer be used by other financial firms. Furthermore, CCPs might protect their own solvency and liquidity with margin calls, thus requiring members to provide additional cash or securities to the CCP. These CCP margin calls could worsen—or even trigger—a liquidity crisis by draining liquid assets from other sectors of the financial industry.

At the very least, the clearing mandate will heighten the financial system’s exposure to more adverse liquidity shocks as more liquid assets are obligated to CCPs for margin requirements. Title VII further compounds this problem because it also requires regulators to set capital and margin requirements in connection with *uncleared* swaps.⁵² Rather than trust counterparties to carefully negotiate OTC swaps with each other (bilaterally), thus keeping risks decentralized throughout financial markets, the Title VII clearing mandate will concentrate these risks in a small number of CCPs.

Registration and Other Requirements. One major consequence of being labeled a swap dealer or a major swap participant is the possibility of higher capital and margin requirements. Commercial end users, for example, fear both having higher regulatory costs passed on to them by existing dealers, as well as being labeled a swap dealer or a major swap participant. Some swaps users have simply left the market and, instead, began using futures to avoid these problems. For instance, end users in the energy industry stopped using nearly 1,000 swaps con-

50. On the other hand, under a mandatory clearing regime, running could be difficult unless there are competing CCPs clearing the relevant type of derivative.

51. For a full list and explanation of these factors, see Hester Peirce, “Derivatives Clearinghouses: Regulatory Designs and Private Solutions,” Mercatus Center at George Mason University, forthcoming.

52. Dodd-Frank § 731 (adding 7 U.S. Code § 6s(e)) (providing for capital and margin requirements for swaps), and § 764 (adding 15 U.S. Code § 78o-8(e)) (providing for capital and margin requirements for security-based swaps). The regulatory agencies have not yet finalized the rules for uncleared swap margins, but this provision surely creates an added incentive against using bilateral swap agreements that avoid central clearing. Former Treasury Secretary Timothy Geithner, a policymaker instrumental in shaping Dodd-Frank, openly explained the rationale behind the provision in this manner. News release, “Remarks by Treasury Secretary Timothy F. Geithner to the International Monetary Conference,” U.S. Department of the Treasury, June 6, 2011, <http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx> (accessed October 9, 2015).

tracts and instead began using futures contracts on the electronic platform run by IntercontinentalExchange (ICE).⁵³ Given the relative complexity of the new framework compared to the regulations for futures markets, it seems likely that other swap users will also choose alternative derivatives as a way to hedge their risk.⁵⁴

Title VII also requires swap dealers, major swap participants, and eligible contract participants to register with the CFTC, a requirement that includes many detailed obligations.⁵⁵ Using the authority granted in Title VII, the CFTC paired this registration requirement with the duty to become a member of a registered futures association (RFA). The CFTC also delegated the registration process to the National Futures Association (NFA), currently the only RFA in the U.S.⁵⁶ The NFA's existing member registration process will now be forced—at a substantial cost—on all those who apply.⁵⁷

Separately, Title VII requires the commission to regulate swap dealers and major swap participants with regard to items such as reporting and record-keeping, documentation requirements, and general business conduct standards.⁵⁸ The CFTC has decided to issue separate rules for each of these Title VII items, and as of this writing they have not been

finalized.⁵⁹ However, these types of rules do tend to protect existing firms from potential competitors, so it is likely that they will eventually serve as barriers to competition. Regardless, the clearest danger is that Title VII will undermine financial stability as the clearing mandate causes more derivatives to be cleared with CCPs. Title VIII of Dodd–Frank addresses this problem with a new regulatory framework for (among others) firms that clear derivatives.

Title VIII: Payment, Clearing, and Settlement

Title I of Dodd–Frank created the Financial Stability Oversight Council (FSOC) and gave it the power to designate certain financial companies and activities for special regulatory oversight.⁶⁰ These firms are commonly referred to as systemically important financial institutions. Title VIII of Dodd–Frank, also known as the Payment, Clearing, and Settlement Supervision Act of 2010, is similar to Title I in that it authorizes the FSOC to single out certain financial companies and activities for special regulatory oversight. Nominally, a key difference is that Title VIII focuses on PCS firms and activities that could threaten the stability of the financial system.⁶¹ The PCS sector includes the CCPs that clear derivatives centrally.

-
53. Matthew Philips, "Traders Take Their Swaps Deals to Futures Exchanges," Bloomberg Business, January 24, 2013, <http://www.bloomberg.com/bw/articles/2013-01-24/traders-take-their-swaps-deals-to-futures-exchanges> (accessed June 22, 2015). In 2012, after the promulgation of many of the rules to which swap dealers would be subject, the CFTC and SEC issued a 169-page joint-rule to clarify ambiguities in a previously issued final rule. See *ibid.*, and "CFTC and SEC Joint Final Rule; Joint Interim Final Rule; Interpretations," *Federal Register*.
 54. Department of the Treasury, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and Federal Housing Finance Agency, "Margin and Capital Requirements for Covered Swap Entities: Proposed Rules," *Federal Register*, Vol. 79, No. 185, September 24, 2014, Part III: Federal Housing Finance Agency, <http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf> (accessed July 30, 2015).
 55. Section 731, 7 U.S. Code § 6s. Additionally, Section 725 (7 U.S. Code § 7a-1) requires derivatives clearing organizations (DCOs) to register with the CFTC, and the details of that process are similar to those for swap dealers, major swap participants, and eligible contract participants.
 56. "Commodity Futures Trading Commission, Registration of Swap Dealers and Major Swap Participants: Final Rule," *Federal Register*, Vol. 77, No. 12, January 19, 2012, p. 2624, <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-792a.pdf> (accessed June 25, 2015).
 57. The non-refundable application fee to register is \$15,000, and the membership dues to the NFA range from \$150,000 (for the smallest major swap participants) to \$1,000,000 (for the largest swap dealers). National Futures Association, "Registration Information for Swap Dealers and Major Swap Participants," <http://www.nfa.futures.org/NFA-registration/sd-and-msp/index.HTML> (accessed October 9, 2015).
 58. In the case of uncleared swaps, swaps dealers and major swap participants are required to notify counterparties of the right to require the firm to segregate funds used as (among other things) margin and collateral. Section 724(c), 7 U.S. Code § 6s(l).
 59. See, for example, CFTC, "Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants," *Federal Register*, Notice of Proposed Rulemaking, Vol. 75, No. 236, December 9, 2010.
 60. Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Background* No. 2900, April 1, 2014, <http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail>.
 61. The expression payment, clearing, and settlement (PCS) firms is not statutory and is used only for descriptive purposes because there is wide variation within this financial sector. For instance, both the Clearing House Payments Company and the Chicago Mercantile Exchange are in the PCS sector, yet their operations are very different.

Title VIII formally charges the FSOC with determining “whether a financial market utility or payment, clearing, or settlement activity is, or is likely to become, systemically important.”⁶² Title VIII is essentially the Federal Reserve’s response to the Title VII clearing mandate. Since the 1990s, the Fed has expressed concern that financial difficulties at CCPs could cause (or worsen) a broader financial crisis, and the Title VII clearing mandate only magnified the risk of such a CCP-induced crisis.⁶³ Title VIII gives designated CCPs explicit access to the Fed’s deposit and payment services, as well as to the Fed’s so-called emergency lending.⁶⁴

Financial Market Utilities (FMUs). Title VIII authorizes the FSOC to identify a new class of financial companies that regulators view as too big to fail.⁶⁵ Specifically, Title VIII authorizes the FSOC to “designate those financial market utilities...that the Council determines are, or are likely to become, systemically important.”⁶⁶ Ostensibly, the term financial market utility refers to the largest clearinghouses and other PCS firms, such as those that serve as CCPs.⁶⁷ Thus, the term “systemically important FMU” refers to a specially designated firm under Title VIII.

The Federal Reserve will now be the primary regulator of any designated FMU that was not previously regulated by either the SEC or the CFTC. Additionally, all designated FMUs will have deposit and payment services with a district Federal Reserve bank—privileges previously reserved for depository institutions.⁶⁸ This change alters the structure of the PCS sector because it allows designated FMUs to transfer large dollar payments *directly* instead of relying on private commercial banks.⁶⁹

Title VIII also grants these systemically important FMUs direct access to the Federal Reserve’s discount window. In particular, the Fed can now provide discount window loans—direct (typically short-term) loans from the central bank—to designated FMUs in “unusual or exigent circumstances.”⁷⁰ This access increases moral hazard because it lowers CCPs’ incentive to accept only the safest clearing members. Furthermore, the recognition that CCPs are federally backed lowers the incentive for clearing members to choose a CCP based on financial strength. In other words, CCPs have a reduced incentive to compete based on their own financial strength because they are now federally backed. The

62. Section 804, 12 U.S. Code § 5463.

63. According to former FDIC chairman Sheila Bair, then-New York Fed President Gerald Corrigan was “among the first to articulate this concern publicly.” Bair, “Regulatory Issues Presented by the Growth of OTC Derivatives,” p. 709.

64. Many aspects of the Title VIII framework are part of a larger international regulatory effort to harmonize financial markets. See CFTC, “Derivatives Clearing Organizations and International Standards: Final Rule,” *Federal Register*, Vol. 78, No. 231, December 2013, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister111513.pdf> (accessed October 9, 2015); CFTC, “Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations: Final Rule,” *Federal Register*, Vol. 78, No. 158, August 2013, <http://www.cftc.gov/ucm/groups/public/@lfederalregister/documents/file/2013-19791a.pdf> (accessed October 9, 2015); and Board of Governors of the Federal Reserve System, “Financial Market Utilities: Final Rule,” *Federal Register*, Vol. 79, No. 214, November 2014, <http://www.gpo.gov/fdsys/pkg/FR-2014-11-05/pdf/2014-26090.pdf> (accessed July 2, 2015).

65. Many of the same criticisms that apply to the FSOC regarding SIFIs under Title I apply to Title VIII. See Michel, “The Financial Stability Oversight Council: Helping to Enshrine ‘Too Big to Fail.’”

66. 12 U.S. Code 5463, Section 804.

67. Title VIII, Section 803(6) defines the term FMU as “any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.” As of this writing, the FSOC has designated eight systemically important FMUs. See “Designated Financial Market Utilities,” Federal Reserve Board of Governors, January 29, 2015, http://www.federalreserve.gov/paymentsystems/designated_fmu_about.htm (accessed February 9, 2015). Internationally, the term “financial market infrastructures” is more common.

68. “Federal Reserve Board of Governors, Financial Market Utilities: Final Rule,” *Federal Register*, Vol. 78, No. 245, 12 CFR Part 234, December 2013, <http://www.gpo.gov/fdsys/pkg/FR-2013-12-20/pdf/2013-29711.pdf> (accessed June 30, 2015).

69. Anna Paulson and Kristin Wells, “Enhancing Financial Stability: The Case of Financial Market Utilities,” Federal Reserve Bank of Chicago, *Chicago Fed Letter* No. 279, October 2010, <https://www.chicagofed.org/publications/chicago-fed-letter/2010/october-279> (accessed February 3, 2015).

70. 12 U.S. Code 5465(b), Section 806(b). This extension of credit is separate from the Fed’s emergency program provisions in Section 13(3) of the Federal Reserve Act, and it does require a majority vote of the Fed Board of Governors.

fact that designated CCPs are now backed by the Federal Reserve magnifies the threats to financial stability caused by Title VII.

At a minimum, these changes provide a competitive advantage to specially designated firms; at worst they invite future taxpayer bailouts. Sheila Bair, former chairman of the Federal Deposit Insurance Corporation, testified to Congress that granting FMUs access to the discount window “not only gives these firms a real advantage over other ‘non’ systemic competitors, it opens up taxpayers to potential losses and creates moral hazard.” Bair also testified that “Title VIII FMUs will very likely become the new GSEs [government-sponsored enterprises] and a new source of system instability,” and recommended that this “unwarranted expansion of the government safety net” be repealed.⁷¹

Title VIII all but ensures that the Federal Reserve—and therefore the federal government—will be viewed as part of even the *nonbank* financial sector’s PCS system. Indeed, the term FMU, a variation of *public utility*, is anticompetitive and shows that federal regulators believe that the financial industry cannot function unless it is highly regulated and largely devoid of competition. The public utility arrangement has effectively created the only lasting class of monopolies that exists in the U.S., and there is a real danger that Title VIII will broadly extend this anticompetitive arrangement to financial firms. (See Appendix B.) Several other Title VIII details pose a direct threat to the ability of competitive financial markets to function properly.

Title VIII: Overly Broad Regulatory Authority

On the surface, Title VIII deals only with regulators’ ability to regulate the largest clearinghouses, such as the specially designated FMUs. However, Title VIII actually gives regulators an overly broad authority that could allow them to impose rules and regula-

tions on financial firms beyond the PCS sector.⁷² One potential source of this broad authority lies in the formal definition of FMU. Section 803(6) defines the term FMU as “any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.”

Title VIII excludes “national securities exchanges, national securities associations, alternative trading systems,” and various other institutions from the FMU definition.⁷³ The exclusion is ambiguous, though, because it also says that these institutions are not FMUs

solely by reason of their providing facilities for comparison of data respecting the terms of settlement of securities or futures transactions effected on such exchange or by means of any electronic system operated or controlled by such entities, provided that the exclusions in this clause apply only with respect to the activities that require the entity to be so registered.⁷⁴ (Emphasis added).

Presumably, these firms could still be identified as an FMU for another reason.

Similarly, the Title VIII definition of an FMU excludes brokers, dealers, transfer agents, and investment companies “solely by reason of functions performed by such institution[s] as part of brokerage, dealing, transfer agency, or investment company activities.”⁷⁵ The exclusion also states that these firms will not be deemed FMUs “solely by reason of acting on behalf of a financial market utility...provided that services performed by such institution do not constitute critical risk management or processing functions of the financial market utility.”⁷⁶ The efficacy of the exclusion thus depends partly on how narrowly the FSOC interprets, for example, *critical risk-management functions*, a term that Dodd–Frank does not define. Indeed, much of Dodd–Frank is writ-

71. “Failing to End ‘Too Big to Fail’: An Assessment of the Dodd–Frank Act Four Years Later,” report prepared by the Republican staff of the Committee on Financial Services, U.S. House of Representatives, 113th Congress, July 2014, p. 81, http://faculty.haas.berkeley.edu/ross_levine/Other/House_Republications_071814_tbtfr_report_final.pdf (accessed February 20, 2015).

72. Similar arguments can be made against Title I of Dodd–Frank, though Title VIII appears more open-ended.

73. 12 U.S. Code § 5462 (6)(B)(i), Section 803(6)(B)(i).

74. *Ibid.*

75. 12 U.S. Code § 5462 (6)(B)(ii), Section 803(6)(B)(ii).

76. *Ibid.*

ten to give regulators flexibility under a mandate of maintaining financial stability.

Other Title VIII definitions provide a similar cause for concern. For instance, Title VIII is ostensibly only concerned with payment, clearing, and settlement activities. However, Section 803(7) defines a “payment, clearing, or settlement activity” to mean “an activity carried out by 1 or more financial institutions to facilitate the completion of financial transactions, but shall not include any offer or sale of a security under the Securities Act of 1933 (15 U.S.C. 77a et seq.), or any quotation, order entry, negotiation, or other pre-trade activity or execution activity.”⁷⁷ Title VIII does not define the term *to facilitate*, but does define *financial transactions* very broadly, so that it includes funds transfers, repurchase agreements, financial derivatives contracts, and “any similar transaction that the Council determines to be a financial transaction for purposes of this title.”⁷⁸

It is also noteworthy that the Title VIII definition of FMU does not explicitly use the words “payment, clearing, or settlement activity.” Instead, the FMU definition identifies firms that operate a multilateral system “for the purpose of transferring, clearing, or settling payments, securities or other financial transactions.” That is, Title VIII does not simply define an FMU as a company that operates a multilateral system “for the purpose of undertaking payment, clearing, or settlement activities,” even though it does define that term. Worse, the term is defined broadly enough that regulators could possibly reach beyond the traditional PCS sector.

Systemically Important FMUs and Activities.

Title VIII states that “the Board of Governors, by rule

or order, and in consultation with the Council and the Supervisory Agencies, shall prescribe risk management standards...governing (A) the operations related to the payment, clearing, and settlement activities of designated financial market utilities; and (B) the conduct of designated activities by financial institutions.”⁷⁹ As noted, several terms in the Title VIII definition suggest that regulators could broaden the FMU concept beyond what is traditionally viewed as the PCS sector. The *activities* designation, however, appears to leave regulators with even more leeway.

Title VIII defines *designated activities* to include those “payment, clearing, or settlement” activities that the FSOC designates as systemically important,⁸⁰ and it defines *payment, clearing, or settlement activities* as an “activity carried out by 1 or more financial institutions to facilitate the completion of financial transactions.”⁸¹ Title VIII also defines *financial institutions* very broadly, including depository institutions, broker dealers, investment companies and advisers, as well as “any company engaged in activities that are financial in nature or incidental to a financial activity.”⁸² These terms are defined so broadly that Title VIII gives federal regulators discretionary authority, with essentially no standards, to potentially regulate practically any financial firm in the securities or capital markets segments.⁸³

After the FSOC makes a systemic designation of an FMU or a financial institution’s activities, Title VIII even gives the Federal Reserve the authority to overrule a firm’s primary regulator. While the SEC and the CFTC—primary regulators of some PCS firms prior to Dodd–Frank—are still allowed to prescribe risk-management standards for the designated firms they supervise, they now must do so in

77. 12 U.S. Code § 5462 (7)(A), Section 803(7)(A).

78. 12 U.S. Code § 5462(7)(B), Section 803(7)(B).

79. 12 U.S. Code § 5464, Section 805(a)(1).

80. 12 U.S. Code § 5462(2), Section 803(2).

81. 12 U.S. Code § 5462(7)(A), Section 803(7)(A).

82. 12 U.S. Code § 5462(5), Section 803(5). The complete citation is “any company engaged in activities that are financial in nature or incidental to a financial activity, as described in section 4 of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)).” Section 1843(k), in turn, broadly describes nonbank financial firms’ activities that can be considered *financial in nature*, including (among others) “Lending, exchanging, transferring, investing for others, or safeguarding money or securities.” See 12 U.S. Code 1843(k)(4).

83. See also Peter Wallison, “The Regulators’ War on Shadow Banking,” American Enterprise Institute, January 2015, pp. 15–17, <https://www.aei.org/wp-content/uploads/2015/01/Regulators-war-on-shadow-banking.pdf> (accessed October 14, 2015). Other financial regulations already apply a very broad definition of financial institutions. For instance, anti-money-laundering regulations apply to financial institutions as defined by Title 31 U.S. Code § 5312. Other than banks (broadly defined), Title 31 defines firms such as insurance companies, jewelry dealers, pawn shops, automobile dealers, and travel agencies as financial institutions.

consultation with the Fed Board of Governors and the FSOC.⁸⁴ Ultimately, the Fed can decide whether these regulations “are insufficient to prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the United States.”⁸⁵ Should the SEC or the CFTC object to the Fed’s proposed standards, a two-thirds vote by the FSOC resolves the dispute.⁸⁶

It would be a mistake to view the Title VIII designation narrowly because it specifically gives the Fed the authority to “prescribe risk management standards.” Title VIII unquestionably allows the Fed to regulate a key aspect of financial firms’ activities in the name of maintaining financial stability. Furthermore, the broad definitions of key Title VIII terms—such as financial transactions and financial institutions—suggest that regulators can use Title VIII to reach well beyond the PCS sector.⁸⁷ Combined, Titles I and VIII of Dodd–Frank give the FSOC—and the Fed—the authority to regulate virtually any aspect of U.S. financial markets on an ongoing basis with an enormous amount of discretion. It is difficult to justify giving such broad power to any federal regulator.

Conclusion

The 2010 Dodd–Frank Act was Congress’s response to the 2008 financial crisis, and two of its titles—VII and VIII—have dramatically altered the way certain derivatives markets are regulated. These titles are largely based on the faulty premise that the swaps market contributed to the 2008 crisis because it was unregulated—a demonstrably false notion. Title VII created a new framework whereby federal regulators micromanage the swaps industry as if regulators can better manage (and accurately price) risks than market participants themselves.

Title VII imposes new clearing, trading, reporting, margining, and business conduct requirements on swap market participants. While all these requirements impose additional costs on swaps users, the Title VII clearing mandate is particularly dangerous. This mandate, the main component of the new regulatory framework, makes it more costly to hedge commercial business risks and also undermines financial stability. The clearing requirement undermines financial stability because it creates moral hazard and concentrates formerly decentralized financial risks in a small number of large clearing firms. Title VIII magnifies these problems by conferring a special status on so-called systemically important central clearing companies.

These firms, identified as designated financial market utilities (FMUs), are the Title VIII counterpart to the so-called SIFIs that Title I of Dodd–Frank addresses. Title VIII provides these companies with direct access to Federal Reserve lending, creating more moral hazard and further undermining financial stability. Title VIII also gives federal regulators a very broad discretionary authority that could ultimately be used to regulate firms in nearly any sector of U.S. financial markets. Together, Titles VII and VIII ensure further consolidation in financial markets, create moral hazard, undermine financial stability, and add to the number of too-big-to-fail institutions. These two titles provide excellent examples of why the Dodd–Frank Act should be repealed.

—*Norbert J. Michel, PhD, is a Research Fellow in Financial Regulations in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*

84. 12 U.S. Code 5464(a)(2)(A), Section 805(a)(2)(A). These risk-management regulations apply both to systemically designated firms and to the financial institutions conducting designated activities for which the CFTC or the SEC is the appropriate regulator.

85. 12 U.S. Code 5464(a)(2)(B), Section 805(a)(2)(B).

86. 12 U.S. Code 5464(a)(2)(E), Section 805(a)(2)(E). Title I of Dodd–Frank does not empower the Fed or the FSOC in exactly the same manner with respect to SIFIs (banks and nonbanks).

87. Even the designation process in Title VIII is a broad, ill-defined authority. For instance, Title VIII provides a broad set of guidelines for FSOC to follow when making a systemic designation, but it includes the catchall: “Any other factors that the Council deems appropriate.” 12 U.S. Code § 5463(a)(2)(E), Section 804(a)(2)(E).

Appendix A

Derivatives: Regulated Before Dodd–Frank

Media accounts have repeatedly claimed—inaccurately—that the derivative known as a *swap* was an unregulated financial product prior to Dodd–Frank.^{A1} While it is true that OTC swaps were not regulated by either the CFTC or the SEC, the overwhelming majority of these swaps were regulated by state and federal banking regulators. Historically, large banks have always been the heaviest users of interest rate swaps, the type of swap that accounts for more than 80 percent of the OTC derivatives market.^{A2}

Federal banking regulators, including the Federal Reserve and the Office of the Comptroller of the Currency (OCC), constantly monitor banks' financial condition, especially the banks' swaps exposure.^{A3} Even the very first iteration of the Basel capital requirements, implemented in the late 1980s, required banks to account for their swaps when calculating regulatory capital ratios. In particular, capital had to be held against the *credit-risk equivalent* to the swaps, essentially treating them as other loans in their risk-adjusted assets.^{A4}

Simply put, none of these transactions took place outside of bank regulators' purview, and there is no shortage of public acknowledgements attesting to this fact. For instance, a 1993 Boston Federal Reserve paper notes that “[b]ank regulators have recognized the credit risk of swaps and instituted capital requirements for them and for other off-bal-

ance-sheet activities, as part of the new risk-based capital requirements for banks.”^{A5} Similarly, a 1996 OCC guidance bulletin notes that:

Bank management must ensure that credit derivatives are incorporated into their risk-based capital (RBC) computation. Over the near-term, the RBC treatment of a credit derivative will be determined on a case-by-case basis through a review of the specific characteristics of the transaction. For example, banks should note that some forms of credit derivatives are functionally equivalent to standby letters of credit or similar types of financial enhancements. However, other forms might be treated like interest rate, equity, or other commodity derivatives, which have a different RBC requirement.^{A6}

Just before the recent crisis, a 2006 OCC report stated:

As a result, derivatives activity is appropriately concentrated in those few institutions that have made the resource commitment to operate the business in a safe and sound manner. Further, the OCC has examiners on site in these large banks to evaluate the credit, market, operational, reputation and compliance risks in the derivatives portfolio on an ongoing basis.^{A7}

-
- A1. Matthew Philips, “Traders Take Their Swaps Deals to Futures Exchanges,” Bloomberg Business, January 24, 2013, <http://www.bloomberg.com/bw/articles/2013-01-24/traders-take-their-swaps-deals-to-futures-exchanges> (accessed October 13, 2015).
- A2. International Swaps and Derivatives Association, “The Value of Derivatives,” 2014, <http://www2.isda.org/about-isda> (accessed June 23, 2015).
- A3. Futures, another type of derivative, were also regulated prior to Dodd–Frank; they were, and still are, regulated differently than swaps. Until 1974, the U.S. Department of Agriculture regulated the futures market, and the first federal statute regulating futures, the Grain Futures Act of 1922, was enacted in the wake of declining crop prices after European agricultural production recommenced post–World War I. The Commodity Futures Trading Commission was created in 1974 soon after newspaper reporters blamed a steep increase in food prices on speculative trading. See Roberta Romano, “A Thumbnail Sketch of Derivative Securities and Their Regulation,” *Maryland Law Review*, Vol. 55, No. 1 (1996), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2985&context=fss_papers (accessed June 22, 2015).
- A4. Katerina Simons, “Interest Rate Structure and the Credit Risk of Swaps,” Federal Reserve Bank of Boston, *New England Economic Review* (July/August 1993), <https://www.bostonfed.org/economic/neer/neer1993/neer493b.pdf> (accessed June 22, 2015). Simons also points out that “to the extent that swaps replace on-balance-sheet obligations of counterparties, they reduce rather than increase the credit risk in the financial system.”
- A5. *Ibid.*
- A6. Office of the Comptroller of the Currency, “Credit Derivatives,” *OCC Bulletin* 1996-43, August 12, 1996, <http://www.occ.gov/news-issuances/bulletins/1996/bulletin-1996-43.html> (accessed October 13, 2015).
- A7. Comptroller of the Currency Administrator of National Banks, “OCC’s Quarterly Report on Bank Derivatives Activities, First Quarter 2006,” <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq106.pdf> (accessed October 13, 2015).

Even the controversial credit default swap used by the failed company AIG took place under the watchful eye of the Office of Thrift Supervision (OTS), a federal banking regulator. The notion that these swaps transactions took place in some shadowy, hidden room of finance, where regulators had no clue what was going on, is absolutely false. Under the new Basel III requirements, banking regulators remain responsible for certifying that banks are meeting their regulatory capital ratios, even when they use swaps. Nonetheless, Title VII of Dodd–Frank gives the CFTC and the SEC explicit authority to regulate the OTC swaps markets and market participants.^{A8}

A8. Section 701, Subtitle A (Regulation of the Over the Counter Swaps Markets), U.S. Code Title 15, Chapter 109, Subchapter I.

Appendix B

PCS Firms and Utilities: A Poor Analogy

Private clearinghouses in the banking industry have existed in the U.S. since at least the 1830s, and there are virtually no historical references to these firms as utilities.^{B1} More specialized payment, clearing, and settlement (PCS) firms, such as those that clear derivatives contracts, have also operated in the U.S. since the 1800s, but few—if any—modern derivatives textbooks refer to these firms as public utilities.^{B2} One of the earliest examples of policymakers comparing PCS firms' operations to those of a public utility dates to the 1970s and serves as a prime case *against* applying the concept to these companies.^{B3}

A large spike in trading volume in the 1960s spurred Congress, the SEC, as well as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), to push for a national clearing system. There was clearly no monopoly in the industry, but the dominant firms—the NYSE and AMEX—worked with Congress to help design this national system.^{B4} Ultimately, Congress passed the Securities Act Amendments of 1975, legislation that marked a major shift in the way the SEC regulated the securities industry.

These amendments required, among other things, clearing firms to register with the SEC, thus subjecting them to extensive regulation. Smaller regional exchanges opposed this effort on the grounds that it would remove competition from the clearing market, but Congress chose to establish a national market despite any anticompetitive effects.^{B5} One former

SEC commissioner involved in the process noted that the “law was an attempted political compromise of deep economic divisions within the financial community, about the extent to which brokers, dealers, banks, and other financial institutions should be permitted to freely compete with one another.”^{B6}

Regardless of which groups benefited the most, there is no doubt that the 1975 amendments greatly influenced the structure of the financial industry. After the amendments passed, the NYSE, AMEX, and the National Association of Securities Dealers merged their respective clearing firms into a single entity named the National Securities Clearing Corporation (NSCC). When the new firm registered with the SEC, the Bradford National Clearing Corporation filed suit claiming (among other things) that the “anticompetitive impact of NSCC’s operation outweighs the beneficial effects thereof.”^{B7} Eventually, a U.S. appeals court sided with the NSCC, and its decision refers to one aspect of clearing as a public utility. The appeals court noted that

for purposes of comparing NYSE and AMEX transactions, NSCC is essentially a public utility that is afforded a monopoly but must offer its services to all qualified customers (its own participants or other clearing agencies) at cost.^{B8} (Emphasis added.)

Aside from whether it did so correctly, the court applied the public utility concept to one narrow

B1. The regulated firms that provided electricity and water were undoubtedly referred to as public utilities long before the Fed was created in 1913, but official documents during this era did not refer to clearinghouses as utilities. See, for instance, J. G. Cannon, “Clearing-House Methods and Practices,” in *Publications of National Monetary Commission*, Vol. 6 (1911), https://fraser.stlouisfed.org/docs/historical/nmc/nmc_491_1910.pdf (accessed February 9, 2015).

B2. See, for instance, John C. Hull, *Options, Futures, and Other Derivatives* (Upper Saddle River, NJ: Pearson Education, 1997).

B3. Neal Wolkoff and Jason Werner, “The History of Regulation of Clearing in the Securities and Futures Markets, and Its Impact on Competition,” *Review of Banking & Financial Law*, Vol. 30 (2010), pp. 313–381.

B4. As of 1975, the NYSE and AMEX (combined) cleared more than 70 percent of all shares traded in the U.S. See *ibid.*, p. 314.

B5. The SEC also sought to increase competitive forces by abolishing rules that tied regional clearinghouses to their respective exchanges. See *ibid.*, p. 336.

B6. Roberta Karmel, *Regulation by Prosecution: The Securities & Exchange Commission Vs. Corporate America* (New York: Simon and Schuster, 1982), p. 114.

B7. Open Jurist, *Bradford National Clearing Corporation v. Securities and Exchange*, 590 F. 2d 1085, <http://openjurist.org/590/f2d/1085/bradford-national-clearing-corporation-v-securities-and-exchange-commission-> (accessed January 26, 2015).

B8. *Ibid.*

aspect of the NSCC's operations based on the finding that certain customers would have no choice but to use some NSCC services. In hindsight, the decision was premature because future technological changes soon radically altered even this narrow aspect of the NSCC's operations. The court did not envision, for instance, millions of consumers with instant access to stock transactions via the Internet and their home computers. Regardless, the court did not refer to the NSCC's overall operation as a public utility, even though it acknowledged that the company effectively had a clearing monopoly in New York. This monopoly, of course, was a direct result of the 1975 amendments.