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MAKING THE CASE FOR CREDIT DEFAULT SWAPS: BALANCING LIQUIDITY CONCERNS WITH POSITION LIMITS UNDER DODD-FRANK

BY ANDREW CALI-VASQUEZ*

INTRODUCTION

Derivatives have long been criticized as being volatile and hazardous financial instruments,¹ but the recent financial crisis triggered a level of public scrutiny and animosity towards derivatives that was heretofore unseen.² Mainstream media leapt at the opportunity to find a target for the public's anger and frustration: banks and hedge funds, armed with balance sheets full of arcane financial instruments.³ Politicians found a new cause with which to galvanize their constituents.⁴ Dodd-Frank was born.⁵

Dodd-Frank, or "The Dodd-Frank Wall Street Reform and Consumer

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¹ See ALICE SCHROEDER, *THE SNOWBALL: WARREN BUFFETT AND THE BUSINESS OF LIFE* 603 (Trade Paperback ed. 2009) (quoting Buffett regarding his opinion on derivatives, which included calling them, "toxic," "time bombs," and "financial weapons of mass destruction"); James B. Kelleher, *Buffet's "Time Bomb" Goes Off on Wall Street*, REUTERS (Sept. 18, 2008), <http://www.reuters.com/article/2008/09/18/us-derivatives-credit-idUSN1837154020080918> (summarizing the link between the beginning of the financial crisis and derivatives).

² See Kelleher, *supra* note 1; Gretchen Morgenson, *It's Time for Swaps to Lose Their Swagger*, N.Y. TIMES, Feb. 28, 2010, at BU1 (stating that the current financial crisis and ones in the future would be "derivatives-fueled").

³ See Editorial, *Investors Beware*, N.Y. TIMES, Nov. 7, 2009, at A22 (stating that derivatives are "the complex instruments that were at the heart of the financial crisis"); Lee Vance, Letter to the Editor, N.Y. TIMES, Apr. 24, 2010, at A18 (referencing the demonization of hedge funds as a result of the mortgage collapse); *Wall St. Booster, in Primary Bid, Shifts From Shouts to Murmurs*, N.Y. TIMES, Sept. 8, 2010, at A1 (noting that a Congressional candidate "described the demonizing of financial executives").

⁴ Congress began the drafting process in 2009, following the Lehman Brothers and Bear Stearns collapses, as well as the passage of TARP. See John L. Ropiequet et al., *An Introduction to the Dodd-Frank Act – The New Regulatory Structure for Consumer Finance Emerges*, 29 NO. 8 BANKING & FIN. SERVICES POL'Y REP. 1, 1 (2010). Bailouts were meant only to be a short-term fix however, whereas Dodd-Frank was intended to implement "sweeping financial regulatory reform." *Id.*; Damian Paletta & Aaron Lucchetti, *Law Remakes U.S. Financial Landscape*, WALL ST. J., July 16, 2010, <http://online.wsj.com/article/SB10001424052748704682604575369030061839958.html>.

⁵ Dodd-Frank was signed into law on July 21, 2010 by President Barack Obama. See Ropiequet et al., *supra* note 4, at 1.

Protection Act,” is a gargantuan statute, reminiscent of the legislation enacted following the Great Depression.⁶ Underlying the details of what the Act actually does, are goals of regulatory empowerment, and an emphasis on the protection of consumers and individual investors.⁷ Title VII of Dodd-Frank focuses on the regulation of over-the-counter (“OTC”) derivatives.⁸ Included in this title is a mandate of authority to the Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”); this mandate gives each agency the authority to impose limits on the positions that “any person” may hold in these derivatives.⁹ The reasoning behind this is fairly easy to discern: If a limit is placed on the size of the position that banks may amass, then damage from fallout would be limited.

This Note focuses on the imposition of position limits on the credit default swap¹⁰ (“CDS”) market, and posits that the grant of authority to the SEC and CFTC under Title VII of Dodd-Frank, which gives each agency the authority to impose position limits on certain OTC derivatives, if applied too harshly, would have a harmful effect on the U.S. lending economy, and consequently on smaller businesses that require regular financing to fund their operations.¹¹ Lenders use CDSs to protect

⁶ See *id.*

⁷ See U.S. SENATE COMMITTEE ON BANKING, HOUSING, & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 1-2, http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (last visited Nov. 22, 2010).

⁸ See generally, Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 8301 (2012). See also DAVIS POLK, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, ENACTED INTO LAW ON JULY 21, 2010 52-53 (2010), http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf (last visited Apr. 12, 2012).

⁹ See 15 U.S.C. § 8301, §§ 737, 763.

¹⁰ ISDA defines “credit default swap” as follows:

A credit default swap is a credit derivative contract in which one party (protection buyer) pays an [sic] periodic fee to another party (protection seller) in return for compensation for default (or similar credit event) by a reference entity. The reference entity is not a party to the credit default swap. It is not necessary for the protection buyer to suffer an actual loss to be eligible for compensation if a credit event occurs.

International Swaps and Derivatives Association, Inc., *Product Descriptions and Frequently Asked Questions*, <http://www.isda.org/educat/faqs.html> (last visited Apr. 12, 2012) [hereinafter *Product Descriptions and Frequently Asked Questions*].

¹¹ See MICHAEL J. CHOW ET AL., NFIB RESEARCH FOUNDATION, RECOMMENDATIONS FOR IMPROVING SMALL BUSINESS CREDIT ACCESS AND FINANCIAL REFORM 2 (2009), [http://www.nfib.com/Portals/0/Recommendations-for-Improving-Small-](http://www.nfib.com/Portals/0/Recommendations-for-Improving-Small-Business_Credit_Access_and_Financial_Reform.pdf)

Business_Credit_Access_and_Financial_Reform.pdf (“Bank credit plays an important role in small business success. Without access to bank

lending, small business owners would have trouble raising the funds they need to operate and grow their businesses.”); WILLIAM J. DENNIS, JR., NFIB RESEARCH FOUNDATION, SMALL BUSINESS CREDIT IN A DEEP RECESSION 7 (2010), <http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small->

themselves against loss in the case of default, changes in a borrower's creditworthiness, and other "credit events."¹² The existence and widespread availability of such protection encourage lenders to extend credit to businesses.¹³ This Note suggests that too severely limiting the access of lenders to these instruments would undermine the way they currently transact business and could ultimately injure borrowers as a result of their inability to obtain affordable financing, or any financing at all.

Section I of this Note provides background information about the structure, use and history of CDSs, particularly in the context of lending transactions; Section II analyzes the relationship between CDSs and commercial lending; Section III discusses the pre-Dodd-Frank regulatory landscape, examines of the historic applications of position limits and related issues, reviews a recently proposed position limit scheme for physical commodities, and proposes a framework for CDS position limits that balances liquidity concerns with the need for increased regulation; and the final section concludes that the implementation of the proposed position limit scheme would provide sufficient protection for the financial markets, while maintaining sufficient liquidity in the CDS markets, for the benefit of lenders and borrowers alike.

The following section provides the reader with a basic understanding of CDSs, including their components and operation, as well as their application in relation to certain financial transactions. This background material should provide a context in which to understand the importance of CDSs to the issuance of debt, and, thus, the need for a position limit framework that properly addresses and balances concerns over lending liquidity with those of ensuring market integrity.

I. CREDIT DEFAULT SWAPS

Credit derivatives (which include CDSs) were created for use in mitigating credit risk associated with a party fulfilling a financial

Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf (summarizing research showing that significantly more business owners were unable to meet their credit needs in 2009 when compared with the mid-2000s).

¹² See MICHAEL DURBIN, ALL ABOUT DERIVATIVES 62 (2d ed. 2006). According to ISDA, there are six officially recognized types of credit events, which include "bankruptcy, failure to pay, restructuring, obligation acceleration, obligation default and repudiation/moratorium." See International Swaps and Derivatives Association, Inc., *Derivatives Consulting Group Glossary*, http://www.isda.org/c_and_a/oper_commit-dcg-glossary.html (last visited Apr. 12, 2012) [hereinafter *Derivatives Consulting Group Glossary*].

¹³ See DURBIN, *supra* note 12, at 63; Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, <http://www.time.com/time/business/article/0,8599,1723152,00.html>.

obligation.¹⁴ One useful way of thinking about a credit derivative is as a “performance guarantee,” such that through a contractual agreement, the performance of a party is guaranteed.¹⁵ In a situation where a lender extends financing, either through a loan or the purchase of bonds, there is risk based on the ability of the borrower to repay the debt; this risk is known as credit risk.¹⁶ One of the chief advantages of credit derivatives is that they allow lenders to divide the overall lending risk into its two main components, interest rate risk and credit risk.¹⁷ Separating the components of the risk involved in a lending transaction make it easier for the lender to protect itself against loss, and in turn will make the lender more likely to lend.¹⁸ This Note focuses on the CDS, which is the most widely used credit derivative.¹⁹ Many credit derivatives are fundamentally similar in that they involve payments by the protection buyer in exchange for said protection, however they can also vary widely with respect to the nature of the protection provided or the terms of default.²⁰

The CDS involves two parties: the protection buyer and the protection seller.²¹ The buyer pays the seller a premium, which is also known as the “credit spread”; that premium usually takes the form of an annual payment, which is calculated as a percentage of the swap’s notional.²² In exchange for these fixed payments which take place over the life of the swap, the protection seller can become obligated to make a large single payment in the event that a credit event occurs.²³ Once the event occurs, and the protection seller has made the payment to the protection buyer, the swap

¹⁴ See DURBIN, *supra* note 12, at 61. ISDA defines credit derivatives as “privately negotiated agreement[s] that explicitly shifts credit risk from one party to the other.” *Product Descriptions and Frequently Asked Questions*, *supra* note 10.

¹⁵ See DURBIN, *supra* note 12, at 62; *Product Descriptions and Frequently Asked Questions*, *supra* note 10 (identifying a credit derivative as a private contract).

¹⁶ See DURBIN, *supra* note 12, at 62.

¹⁷ See *id.*

¹⁸ See *id.* at 62-63.

¹⁹ See *Derivatives Consulting Group Glossary*, *supra* note 12; Julio Arboleda-Florez & Joël Bessis, *Risk Management in Banking*, 9.1 (2011), available at <http://books.google.com/books?id=oq-MAjw2ezQC&pg=PT200&lpg=PT200&dq=cds+most+widely+used+credit+derivative&source=bl&ots=CneCytrv5&sig=P262gussNBF0tS2lfb4YY3ev4w&hl=en&sa=X&ei=yZKMT6yjG8b40gHxrbjxCQ&ved=0CDkQ6AEwAzgK#v=onepage&q=cds%20most%20widely%20used%20credit%20derivative&f=false>.

²⁰ See DURBIN, *supra* note 12, at 63-68; *Distressed Investing: Selected Topics*, American Bankruptcy Institute, Georgetown Univ. Law Ctr. CLE, Oct. 5, 2007, 071005 ABI-CLE 5.

²¹ See DURBIN, *supra* note 12, at 64.

²² See *id.* at 63-65. “For credit default swaps, notional amount refers to the par amount of credit protection bought or sold, equivalent to debt or bond amounts, and is used to derive the premium payment calculations for each payment period and the recovery amounts in the event of a default.” International Swaps and Derivatives Association, Inc., *CDS Marketplace*, http://www.isdacdsmarketplace.com/market_statistics/understanding_notional_amount.

²³ See DURBIN, *supra* note 12, at 64.

terminates.²⁴ This process is best illustrated through an example.

Suppose that X (a company building a portfolio of investments to make use of its excess capital) purchases \$10 million dollars worth of bonds issued by Y (a small operating company which sought to raise capital to help finance its business through a debt issuance).²⁵ Although Y appears to be a financially sound company, X wishes to maintain and protect the value of its investment, so it contacts Z (an investment bank) to execute a CDS. The notional of the swap is \$10 million dollars, which is the face value of the bonds issued by Corporation Y, and the tenor of the swap will match the maturity period of the bonds (so if the bonds have a maturity of ten years, the swap will be structured to cover that same period of time). We are left with the following transaction: X faces Z in a CDS, in which X is the protection buyer and Z is the protection seller; the swap references the bonds issued by Y, who is the reference entity (and not a party to the swap). Z will charge X an annual premium which will be a percentage of the \$10 million dollar notional, in exchange for the credit protection afforded by the swap.

Now suppose that Y starts to find itself in financial distress and eventually files for bankruptcy. The filing (and possibly the occurrence of financial distress, depending on the extent and terms defined by the parties to the swap) will be a credit event. Assume that as a result of the bankruptcy filing taking place, the bonds are now worth \$2 million dollars, which means X has incurred a loss in its investment of \$8 million dollars.²⁶ The parties, X and Z, now have two options, depending on the way the swap was structured; they can either cash-settle or physically settle.²⁷ If the parties cash-settle, Z will make a cash payment to X for the amount of the loss stemming from the event, namely \$8 million dollars, after which the swap will terminate and the parties will owe each other no further obligation.²⁸ If the parties physically settle, there will be an exchange once the event occurs; X will physically deliver the bonds issued by Y, which underlie the swap, and in exchange for those bonds, Z will pay X the notional amount of the swap, meaning \$10 million dollars (which is also the original face value of the bonds).²⁹ That exchange would conclude the

²⁴ See ROBERT W. KOLB & JAMES A. OVERDAHL, FINANCIAL DERIVATIVES 174 (3d ed. 2003).

²⁵ See DURBIN, *supra* note 12, at 65. The value of the bond portfolio is adapted from an example provided here.

²⁶ See *id.* The amount of the devaluation of the bond portfolio is adapted from an example provided on this page.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

obligations between the parties and the swap would be terminated.³⁰

This example, in a nutshell, describes a typical CDS transaction. The reader should note that the reference obligation, meaning the bonds issued by Y in the example above, is not limited to bonds.³¹ Some other typical underlying assets could be unsecured loans, asset-backed securities, or syndicated secured loans.³² Thus, if we substitute \$10 million dollars in bonds, with a \$10 million dollar unsecured loan from X to Y in the above example, the same outcome would result once the credit event occurred: X could physically deliver the loan to Z and receive the full \$10 million, or simply receive a single, cash payment for the decrease in value of the loan.

The example above is seemingly mundane, but demonstrates the usefulness of the transaction for each of the parties involved. X buys protection for the financing which it extended to Y; Z receives an annual principal payment, which continues as long as no credit event occurs; and Y, at least arguably, is more likely to obtain financing at a reasonable rate because potential lenders know they will be able to purchase protection against Y's default. The reader can see that through the use of the swap, the lender can obtain something akin to an insurance policy to protect its loan (or bond portfolio), and thus is incentivized to lend at a more affordable interest rate, which in turn allows increased borrowing, which is obviously useful and essential to most businesses.

Having addressed the fundamentals of credit derivatives and CDSs, the following section of this Note examines the relationship between CDSs (specifically CDS liquidity) and the lending markets, particularly with respect to the availability of financing. The need to preserve liquidity and thereby ensure the availability of financing underlies the need for a position limit framework discussed in Section III.

II. ANALYSIS OF THE RELATION BETWEEN THE CDS AND LENDING MARKETS

What effect does CDS liquidity³³ actually have on bank lending?³⁴ Frank

³⁰ See KOLB & OVERDAHL, *supra* note 24, at 174.

³¹ See *Derivatives Consulting Group Glossary*, *supra* note 12. A "reference obligation" is defined as "[a] bond, loan or other payment obligation, issued by the reference entity." *Id.* The "reference entity" is defined as "[t]he underlying company or Sovereign which issues the debt obligation or obligations which constitute the reference obligation(s) under a credit derivative." *Id.*

³² See *id.* The definition of "Loan-Only Credit Default Swap," which is a type of CDS in which the reference obligation is a "syndicated secured loan." *Id.* That definition contrasts the loan-only reference obligation to those used in other CDSs, which can include a "bond, unsecured loan or asset backed security." *Id.*

³³ See Francis Cianfrocca, *Coffee & Markets, How Much Credit Should We Have in the World?*

severely restrictive position limits] during periods of market stress would in fact exacerbate . . . funding issues.”⁴²

Alessio Saretto and Heather Tookes recently addressed the issue of whether “the ability of suppliers of debt to hedge risk through credit default swap (CDS) contracts impact firms’ capital structures.”⁴³ They conclude that firms that have debt referenced by CDSs are able to borrow more proportionate to their liquid assets and are able to borrow with repayment terms over longer periods of time than those firms whose debt was not referenced by CDSs.⁴⁴ Generally speaking, during periods where borrowing is difficult, the firms whose debt underlies CDSs have greater access to capital than those firms whose debt is not hedged through CDS positions.⁴⁵ Saretto and Tookes find two main reasons why widespread availability of CDSs increase ease with which businesses can borrow.⁴⁶

First, while treasury bonds⁴⁷ are generally considered to be a more conservative investment than corporate bonds, a liquid CDS market widens the appeal of investing in corporate bonds because through the execution of CDSs, the risk for the purchaser is reduced.⁴⁸ When small or new businesses opt to issue publically traded debt, their debt is often given a low grade by ratings agencies because of either a poor or virtually non-existent repayment history.⁴⁹ The benefits of this type of financing, particularly in the case of “smaller or younger companies” cannot be overstated, as borrowing through bond issuance generally has “fewer restrictive covenants than bank financings.”⁵⁰ That in turn gives the company greater operational freedom, which again is particularly beneficial to early-stage and small companies.⁵¹ Also, the fact that the offering is

⁴² *See id.*

⁴³ ALESSIO SARETTO & HEATHER TOOKES, CORPORATE LEVERAGE, DEBT MATURITY AND CREDIT DEFAULT SWAPS: THE ROLE OF CREDIT SUPPLY 1 (2010), <http://w4.stern.nyu.edu/salomon/docs/conferences/Yale-Tookes%20-%20CDS%20&%20Leverage.pdf>.

⁴⁴ *See* SARETTO & TOOKES, *supra* note 43, at 1.

⁴⁵ *See id.*

⁴⁶ *See id.*, at 1-2.

⁴⁷ This term is used to denote all maturities of U.S. government-issued debt, as opposed to just long-dated issues.

⁴⁸ *See* SARETTO & TOOKES, *supra* note 43, at 2.

⁴⁹ *See* JANE TRIPP HOWE, JUNK BONDS: ANALYSIS & PORTFOLIO STRATEGIES 13 (1988). *See also* Rose Johnson, *The Advantages of Corporate Sinking Funds*, HOUSTON CHRONICLE, <http://smallbusiness.chron.com/advantages-corporate-sinking-funds-34244.html> (last visited Oct. 18, 2013) (explaining that “[s]mall businesses with poor credit ratings typically must pay investors greater interest rates on bonds to compensate for the risk investors take when investing in the company”).

⁵⁰ *Id.*

⁵¹ *See id.*; *see also* Nash et al., *Determinants of Contractual Relations Between Shareholders and Bondholders: Investment Opportunities and Restrictive Covenants*, 9 J. CORP. FIN. 201, 205 (2001), available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.394&rep=rep1&type=pdf> (observing that “when firms refinance bank debt with junk bonds, the junk bonds are less restrictive

made publically (i.e., traded on an exchange) means “greater public awareness of the issuing company and its products.”⁵² Thus, because liquidity in the CDS markets increases the appeal of investing in corporate debt through a reduction of credit risk, companies, particularly young and/or small companies whose debt would otherwise be rated as low-grade, are presumably able to borrow more easily through bond offerings for which the market will have a greater appetite. Simply stated, CDSs make these offerings less risky which increases the likelihood of success by the issuer.

Second, the use of single-name CDSs (i.e., those that reference the debt of a single borrower) reduces regulatory capital requirements, which in turn “increas[es] the[] willingness [of banks and insurance companies] to supply debt capital to firms.”⁵³ In the U.S., depository institutions are required to keep capital on hand, the amount of which is determined based on the credit risk of the balance sheet asset (i.e., the loan to the company).⁵⁴ By using CDSs, a lender reduces the credit risk of its balance sheet assets (by transferring that risk to the counterparty in the swap), which requires it to keep less capital on hand, thereby allowing it to make more loans. In aggregate, the increased ability to lend means that companies, particularly smaller ones that might otherwise be perceived as too risky an investment for the lender, may have increased access to capital, due to lenders having a liquid CDS market in which they can trade a borrower’s credit risk.

Saretto and Tookes find that “the introduction of CDS markets increases leverage and extends debt maturity,”⁵⁵ meaning that companies are able to borrow more for every dollar that they have and are able to borrow over longer periods of time. The benefits are as follows: Greater leverage means

than the bank debt. . . . [and] that firms with the need for additional flexibility benefit the most from reducing the restrictions in their debt.”)

⁵² HOWE, *supra* note 49, at 13.

⁵³ See SARETTO & TOOKES, *supra* note 43, at 2.

⁵⁴ See Darryll Hendricks & Beverly Hirtle, *Bank Capital Requirements for Market Risk: The Internal Models Approach*, FRBNY ECONOMIC POLICY REVIEW, 2 (Dec. 1997), <http://app.ny.frb.org/research/epr/97v03n4/9712hend.pdf> (“[Capital requirements are] minimum amounts of capital to be held against various categories of on- and off- balance sheet positions. . . . [including] debt and equity instruments” “[These requirements are implemented to offset] the risk of loss from adverse movements in the market values of assets, liabilities, or off-balance sheet positions.”); see also *Capital Requirement*, INVOSTOPEDIA, <http://www.investopedia.com/terms/c/capitalrequirement.asp#axzz1isYMFj8l> (last visited Oct. 18, 2013) (“The standardized requirements in place for banks and other depository institutions, which determines how much liquidity is required to be held for a certain level of assets through regulatory agencies These requirements are put into place to ensure that these institutions are not participating or holding investments that increase the risk of default and that they have enough capital to sustain operating losses while still honoring withdrawals.”).

⁵⁵ See SARETTO & TOOKES, *supra* note 43, at 2-3.

more operating income and a longer repayment period means smaller incremental payments, which increases the likelihood that those payments will be made on time, meaning less likelihood of default.

Also, Saretto and Tookes find that CDS liquidity has the greatest impact “in the years in which credit supply constraints are most binding,” which “suggests CDS contracts are an important tool that investors can use to relax credit constraints and provide investment financing to firms during downturns.”⁵⁶ Generally speaking, debt markets tend to be illiquid, particularly in times of economic stress.⁵⁷ CDSs counteract this illiquidity because parties can readily trade the credit risk of a debt instrument, “which is a major component of [its] value.”⁵⁸ As a result, active trading of CDSs makes debt more liquid, because lenders and investors are reassured that even locked into something traditionally thought of as illiquid, such as a loan, the lender can execute a CDS which passes the credit risk of that loan to another party.⁵⁹ The transaction benefits the risk averse lender who is able to reduce the risk of default; it benefits the borrower because lenders are more apt to extend credit; and it benefits the investor who has an appetite for risk, because he has a view of the value of this particular credit risk and believes that his position of incurring this risk will be profitable. Simply stated, if the liquidity of the CDS markets is “severely restrict[ed]” through the imposition of position limits, “the whole world will pay a lot more for capital.”⁶⁰

Based on the foregoing, the relation between and the importance of CDSs to the availability of financing should be clear, as should the risk of impairing CDS liquidity through the overly aggressive imposition of position limits. The following section discusses the historic regulation of CDSs and use of position limits, analyzes recently proposed position limit framework for commodity derivatives, and sets forth a proposal for the imposition of position limits on CDSs.

⁵⁶ *Id.* at 3.

⁵⁷ See Felix Salmon, *Greece Reaps the Benefit of its CDS Market* (Mar. 4, 2010), <http://blogs.reuters.com/felix-salmon/2010/03/04/greece-reaps-the-benefit-of-its-cds-market/> (“One of the big problems with debt markets is that, especially during times of stress, they become very illiquid.”). See also Cianfrocca, *supra* note 33. (“The credit-default swap is an instrument that overcomes the illiquidity of fixed-income assets.”).

⁵⁸ Cianfrocca, *supra* note 33.

⁵⁹ See *id.*

⁶⁰ *Id.*

III. REGULATION

Until recently, there was very little regulation in place that impacted CDSs.⁶¹ This might seem surprising given the magnitude of the global CDS market;⁶² however, prior to the enactment of Dodd-Frank, “federal regulation of CDSs [had] been limited to the Securities and Exchange Commission’s . . . jurisdiction over CDSs for fraud, market manipulation, and insider trading.”⁶³ Additionally, federal banking regulations had some input because of the large number of commercial banks which also participated in CDS trading.⁶⁴

“Title VII of the Act sets forth the new legislative framework for derivatives,”⁶⁵ with particular attention paid to the regulatory treatment of OTC derivatives. Jurisdiction over OTC derivatives is divided into two broad categories: “swaps” and “security-based swaps.” “Swaps” are regulated by the CFTC; “security-based swaps” are regulated by the SEC.⁶⁶ Despite the jurisdictional schism, Dodd-Frank attempts to “establish parallel rules for swaps and security-based swaps,”⁶⁷ and does so through amendments to the Commodity Exchange Act and the Securities Exchange Act of 1934.⁶⁸

⁶¹ See Houman B. Shadab, *Counterparty Regulation and its Limits: The Evolution of the Credit Default Swaps Market*, 54 N.Y.L. SCH. L. REV. 689, 690 (2010) (stating that historically, OTC derivatives were subject to minimal federal regulation).

⁶² According to the Bank of International Settlements, as of June 2010 the size of the CDS market globally was \$30 trillion U.S. dollars in notional amount outstanding. See Bank for International Settlements, *Table 19: Amounts Outstanding of Over-the-Counter (OTC) Derivatives*, <http://www.bis.org/statistics/otcder/dt1920a.pdf> (last visited Nov. 22, 2010). Note that that amount includes both single-issue/narrow-index and multi-name/index CDSs, which are given different treatment under Dodd-Frank, including which federal agency is responsible for regulating them. See Sidley Austin LLP, *Dodd-Frank Essentials for End-Users of OTC Derivatives – Update 1: What is a “Swap”?* 3 (2010), <http://www.sidley.com/files/News/065b7999-8bf3-41f5-91b2-692822203a0e/Presentation/NewsAttachment/0a3bee42-46aa-4b71-8216-a5156a5c4854/investment%20funds%20update%2081710.pdf>. This disparate treatment is discussed in greater detail later in this section.

⁶³ Shadab, *supra* note 61, at 692.

⁶⁴ See *id.* See also Adam Reiser, *An Economic Analysis and Legal Framework for Credit Default Swap Regulation*, 4 NORTH CAROLINA BANKING INSTITUTE 101, 106 n.29 (2009), available at <http://www.law.unc.edu/documents/journals/ncbank/balancesheet/aneconomicanalysisandlegalframeworkforcreditdefaultswapregulation.pdf> (citation and internal quotation marks omitted) (stating that “the Federal Reserve Bank and the Office of the Comptroller have helped fill the CDS regulatory void” left by the Commodities Exchange Act).

⁶⁵ Covington & Burling LLP, *New Rules for Derivatives* 1 (2010), <http://www.cov.com/files/Publication/f11bd6db-d8f2-46d1-b91b-da0b30a44157/Presentation/PublicationAttachment/88322576-8e12-48ab-8c61-daca964bb4e0/Dodd-Frank%20Act%20-%20New%20Rules%20for%20Derivatives.pdf>.

⁶⁶ § 737, 124 Stat. at 1722; § 763, 124 Stat. at 1778; Covington & Burling LLP, *supra* note 65, at 1.

⁶⁷ Covington & Burling LLP, *supra* note 65, at 2.

⁶⁸ § 737, 124 Stat. at 1722; § 763, 124 Stat. at 1778; Covington & Burling LLP, *supra* note 65, at 2 n.1.

Within Title VII, and the focus of this Note, is the mandate issued to the CFTC and SEC to establish position limits for certain OTC derivatives, which includes CDSs.⁶⁹ Under Title VII, the SEC and CFTC now have the “authority to issue rules (or direct any self-regulatory organization to issue rules) limiting the size of positions in [CDSs] that may be held by any particular person or entity.”⁷⁰ For CDSs, the method used to calculate these limits is still undecided, and so CDS users await the determinations made by the SEC and CFTC.⁷¹

Adding to the uncertainty is the question of which agency will be responsible for the regulation of CDSs.⁷² The two terms, “swap” and “security-based swap,” each include CDSs within their scope.⁷³ Thus, the SEC and CFTC will both have jurisdiction over CDSs.⁷⁴ The distinction which determines the extent of that jurisdiction is the reference obligation underlying the CDS.⁷⁵ In the case of single-name CDSs, or CDSs referencing a narrow-based index of securities, the SEC will have jurisdiction; in the case of CDSs referencing broad-based security indices, or multiple loans or an index of loans, the CFTC will have jurisdiction.⁷⁶ Regardless of the jurisdictional curiosities, the important takeaway is that position limits can and will be imposed on CDSs in the near future.⁷⁷

A. Position Limits Historically

Generally defined, position limits provide a cap on the number of a

⁶⁹ § 210, 124 Stat. at 1486; § 761, 124 Stat. at 1756; see Sidley Austin LLP, *supra* note 62, at 3 (noting that some of the products covered by Title VII will be subject to mandatory clearing requirements).

⁷⁰ Eric J. Peterman et al., Weil, Gotshal & Manges LLP, *The Dodd-Frank Act and Credit Derivatives: A Market Transformed* 5 (2010), <http://www.weil.com/files/Publication/322a598a-722d-4d09-872c-b6456dac5828/Presentation/PublicationAttachment/8afd1bdf-69d1-403d-8113-c241e1e002f5/the%20dodd%20frank%20act%20and%20credit%20der.pdf>.

⁷¹ Eric J. Peterman et al., *supra* note 70, at 5; see Covington & Burling LLP, *supra* note 65, at 2 (discussing that the CFTC and SEC will have to clarify issues regarding CDSs).

⁷² See Sidley Austin LLP, *supra* note 62, at 3 (“[I]t remains to be seen how the SEC will choose to regulate these products going forward.”); see also Eric J. Peterman et al., *supra* note 70, at 7 (“The economics that will drive the CDS market in the coming years will be affected directly by the manner in which the SEC and CFTC undertake their respective roles in promulgating new rules under the Act.”).

⁷³ § 737, 124 Stat. at 1722; § 763, 124 Stat. at 1778; see Covington & Burling LLP, *supra* note 65, at 2 (noting that the definition of security-based swaps “leaves some doubt as to the classification of credit default swaps”).

⁷⁴ Covington & Burling LLP, *supra* note 65, at 2.

⁷⁵ *Id.* at 8.

⁷⁶ § 737, 124 Stat. at 1722; § 763, 124 Stat. at 1778; Covington & Burling LLP, *supra* note 65, at 2.

⁷⁷ The SEC and CFTC do have the authority to exempt any class of derivatives from the position limits; however, it seems unlikely, despite the arguments expressed in this Note, that they will do so in the case of CDSs. See § 737, 124 Stat. at 1724; § 763, 124 Stat. at 1778.

particular type contract that a person is allowed to hold or control.⁷⁸ The historical purpose of position limits is to prevent “excessive speculation causing sudden or unwarranted volatility in commodity prices” and “to detect and deter potential price manipulation.”⁷⁹ Initially, limits were imposed on contracts (i.e., futures and options) that were subject to physical delivery, especially during the “spot month,” meaning “the month when the futures contract matures and becomes deliverable.”⁸⁰ The CFTC points out that “[s]tricter limits in the spot month are important because that is when physical delivery may be required and . . . [the commodity] may be more vulnerable to price fluctuation caused by abnormally large positions or disorderly trading practices.”⁸¹ Additionally, position limits may be imposed on financial futures and options that have the potential for vulnerability to excessive speculation.⁸² Presumably what makes a physically deliverable commodity so vulnerable to speculation is that its supply is finite at any given time, making it easier for a would-be

⁷⁸ See, e.g., 17 C.F.R. § 150.2 (establishing position limits for certain agricultural contracts).

⁷⁹ PAUL QUENEAU, *THE POTENTIAL IMPACT OF POSITION LIMITS IN THE ENERGY MARKETS* 1 (2010), http://www.rkco.com/Corporate/Admin/AttachmentFiles/wall_street_argus/RK_WallStreetArgus_4_10_pos%20limitsf.pdf; Fred Seamon, *Speculative Position Limits and Hedge Exemptions*, CME GROUP, 5 (2008), http://www.cmegroup.com/trading/agricultural/files/Spec_Limits_and_Hedge_Fund_Exemptions_070708.pdf;

⁸⁰ U.S. COMMODITY FUTURES TRADING COMMISSION, *Speculative Limits*, <http://www.cftc.gov/IndustryOversight/MarketSurveillance/SpeculativeLimits/index.htm> (last visited Apr. 2, 2012). See Chris McMahon, *Financial Settlement vs. Physical Delivery* (Jul. 25, 2006), <http://www.futuresmag.com/Issues/2006/8/Pages/Financial-settlement-vs-physical-delivery.aspx> (explaining that the right of physical delivery with respect to a futures contract “[is] a legally binding agreement to take, or to make, delivery of a pre-specified quantity and quality of a commodity on a predetermined date at a predetermined location.”); *Physical Delivery*, INVESTOPEEDIA, <http://www.investopedia.com/terms/p/physicaldelivery.asp> (last visited Mar. 12, 2011) (stating that “Physical Delivery” is a “[t]erm in an options or futures contract which requires the actual underlying asset to be delivered upon the specified delivery date”); Jon Matonis, *The Monetary Future, Hunt Brothers Demanded Physical Delivery Too* (Jan. 28, 2010), <http://themonetaryfuture.blogspot.com/2009/01/hunt-brothers-demanded-physical.html> (The “Hunt brothers silver saga of 1979-1980” provides a useful example of physical delivery: “Forty million oz of silver was loaded onto the planes and they immediately flew to Zurich where they were met by another convoy of armored trucks”) (internal quotation marks omitted).

⁸¹ U.S. COMMODITY FUTURES TRADING COMMISSION, *supra* note 80. See also Willkie Farr & Gallagher LLP, *CFTC Seeks Comments on Trading Practices* 3 (2010), http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3624%5CCFTC_Seeks_Comments_On_Trading_Practices.pdf (“[H]ow should the CFTC distinguish between orderly and disorderly trading?”); Asjlynn Loder, *Commodity Manipulation May Be Easier to Prove After Overhaul*, BLOOMBERG BUSINESSWEEK (July 19, 2010, 12:01 AM), <http://bx.businessweek.com/financial-regulation/view?url=http%3A%2F%2Fnoir.bloomberg.com%2Fapps%2Fnews%3Fpid%3D20601068%26sid%3Da224KAZmQrM> (comparing the standard for whether trading is orderly or disorderly to the standard for pornography and stating that “[t]he CFTC is going to say, we know orderly when we see it. And that’s going to be a bone of contention”).

⁸² See U.S. COMMODITY FUTURES TRADING COMMISSION, *supra* note 80.

speculator to “corner the market in [that particular] commodity.”⁸³ The earliest position limits imposed under federal law were those on wheat and other grains in 1938, followed by cotton and then soybeans in the 1940s.⁸⁴

Position limits are determined based “the deliverable supply of the underlying commodity and on the size of the corresponding futures and options market.”⁸⁵ Limits are generally divided into three categories, which are spot month, single month, and all months combined.⁸⁶ Spot month position limits set a maximum on the number of futures or options contracts that an investor may hold in a contract month that “is entering or has entered its delivery cycle.”⁸⁷ The spot month position limit applies once investors have notice the delivery cycle is being entered.⁸⁸ The CFTC

⁸³ Megan McArdle, *Position Limits on Oil Trading: Why Not?*, THE ATLANTIC (July 24, 2008, 1:25 PM) <http://www.theatlantic.com/business/archive/2008/07/position-limits-on-oil-trading-why-not/3875/>.

⁸⁴ See Jim Overdahl, *Federal Speculative Position Limits*, U.S. COMMODITY FUTURES TRADING COMMISSION, 4 (2004), http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/aac_07212004_comments.pdf. The original version of the Commodity Exchange Act of 1936 “allowed the Commission to set the same or different limits for different commodities, markets, and delivery months.” Allen B. Paul, *Speculative Position Limits* 124 (1980), available at <http://www.farmlandoc.illinois.edu/irwin/archive/papers/Research%20on%20Speculation9.pdf>. For example, in the case of potatoes, “lower limits were set for contracts maturing late in the marketing year,” which presumably was tied potato harvesting season. *Id.* Position limits, according to some critics, made more sense prior to the Internet when market data was not available instantaneously. See *Position Limits Origin and Market Effects*, BEFORE IT’S NEWS (Dec. 22, 2010 8:53 AM), http://beforeitsnews.com/story/322/117/Position_Limits_Origin_and_Market_Effects.html. At that time it was easier for market participants to “corner” the market in order to drive prices higher, a practice that was deemed detrimental to the market and consumers; position limits prevented this activity by limiting the number of contracts that a speculator could hold and thereby “kept the players in the market honest.” *Id.*

⁸⁵ Seamon, *supra* note 79, at 5. In the case of the spot month position limits, which “may be no greater than one-quarter of the estimated deliverable supply at the futures delivery points,” the application would be as follows:

[I]f the minimum monthly deliverable supply over an entire crop year at all corn futures delivery points is 12 million bushels, one-quarter of this amount is 3 million bushels. Since each corn futures contract represents 5,000 bushels, the corn spot month speculative limit would be 3 million divided by 5,000 or 600 contracts.

Id., at 5. While the earliest position limits were imposed by federal regulation, in 1981, the government required exchanges to set position limits for commodities that were not subject to federal position limits. See Overdahl, *supra* note 84, at 4. The “size” of the market refers to the number of contracts, which is demonstrated later in the discussion of how non-spot month limits are calculated using the “open interest” which is a metric based on the number of contracts traded. See *infra* notes 119-21 and accompanying text.

⁸⁶ See Seamon, *supra* note 79, at 1-2; *Commodity Futures Trading Comm’n, Q & A- Position Limits for Futures and Swaps*, CFTC.GOV, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pl_qa_final.pdf (last visited Oct. 18, 2013).

⁸⁷ Seamon, *supra* note 79, at 1. The delivery cycle is discussed in *infra* note 88. Also see *supra* note 80 for a discussion of what happens when physical delivery takes place.

⁸⁸ The following example demonstrates how this would operate in the context of corn futures contracts:

[S]ellers may give their intention to deliver against corn futures contracts two business days prior to the

and exchanges also establish position limits for single (non-spot) months and all months combined.⁸⁹

While market participants acknowledge the value of having position limits in place, investors and industry groups have been extremely vocal in their concerns regarding the imposition of position limits, particularly over fears that position limits have the potential to decrease market liquidity and increase transaction costs.⁹⁰ Also, critics of position limits have more recently suggested that over-aggressive use of position limits will simply drive U.S. investors to foreign markets and counterparties that are outside the reach of U.S. regulation.⁹¹ Those critics argue that incentivizing investors to transact business with non-U.S. entities and on non-U.S. exchanges decreases market transparency, limiting the amount of regulatory oversight available and putting the markets at greater risk for another decline.⁹²

The overwhelmingly restated concern is that position limits decrease liquidity and increase transaction costs and that those costs are passed along to consumers (or in the case of this Note, small businesses seeking financing). For example, ISDA, in a letter to the CFTC, noted that “position limits can be a useful tool but that they can also restrict market liquidity and impair the price discovery function of the markets utilized by a broad range of market participants, particularly commercial hedgers.”⁹³

delivery month. For the July 2008 Corn futures contract that recently went into delivery that date was June 27, 2008. Thus, all speculators in the corn futures market could hold no more than 600 net long or net short positions in the July 2008 Corn futures contract at the close of business on June 27th.

Seamon, *supra* note 79, at 1.

⁸⁹ *Id.* at 2. A single month position limit sets the maximum number of “net long or net short positions a speculator may hold in one non-spot contract.” *Id.* In the case of an all months position limit, using soybeans as an example, the speculator may hold no more than 10,000 contracts net long or short (which includes futures and options) combined. *Id.* “The spot month is the nearest month in which delivery can be made on a futures contract.” *Spot Month*, REUTERS FINANCIAL GLOSSARY, http://glossary.reuters.com/index.php/Spot_Month (last visited Oct. 18, 2013). An example of this would be if trading of a certain commodity contract is taking place in the end of October, then the spot month would be November, since that would be the next month in which delivery could take place (because the October contracts would already have expired). See *Spot Delivery Month*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/spotmonth.asp> (last visited Apr. 12, 2012).

⁹⁰ See, e.g., *infra* notes 93-95 and accompanying text. Note that the term “market participant” denotes a number of different groups including institutional and retail traders and investors, and also industry regulators. “Transaction cost” refers to the cost of hedging, which would arguably increase if limits reduced liquidity in the exchange traded markets. QUENEAU, *supra* note 79, at 2. This is similar to the discussion in Section III of this Note, *supra*, which explains that by reducing the availability of CDSs, it becomes more expensive to hedge loans or other debt positions; that expense in turn is passed on to the borrower through less favorable terms.

⁹¹ See, e.g., *infra* note 94 and accompanying text.

⁹² See, e.g., *id.*

⁹³ Letter from Robert Pickel, Exec. Vice Chairman, ISDA, & Kenneth E. Bentsen, Jr., Exec. Vice President, SIFMA, to David Stawick, Sec’y, *Commodity Futures Trading Comm’n* (Jan. 11, 2011), available at <http://www.isda.org/speeches/pdf/CFTC-Position-Limits-Pre-Comment.pdf>. See also *supra*

Even two of the CFTC's own commissioners have previously "expressed concerns that [position limits] could drive business out of the United States to [foreign exchanges], or to unregulated OTC markets, and thus might impair the liquidity and price discovery functions of U.S. futures markets."⁹⁴ In the context of swap markets, "proposed restrictions on swap dealers' use of exchange-traded markets to manage their risks may cause swap dealers either to pass along their increased risks to their swaps counterparties (e.g., airlines, pooled investment vehicles, pension plans) in the form of higher pricing and more restrictive terms or to cease entering into further swap transactions entirely once their futures limits are reached. Either action could negatively impact market liquidity."⁹⁵

Some critics have also argued that trading without position limits would provide the market with more accurate information in terms of the value of the assets being bought and sold.⁹⁶ The theory is that as prices change as a result of trading activity (i.e., buying and selling which reflects demand), end-users adjust their consumption accordingly⁹⁷; however, if trading is artificially impaired through position limits, then there is insufficient market activity to change the price to reflect the accurate demand in the marketplace and thus end-users operate without knowing the true value of

note 10 and accompanying text (defining ISDA as the "International Swaps and Derivatives Association"); Maureen O'Hara, *Presidential Address: Liquidity and Price Discovery*, J. FIN. (Aug. 2003) <http://www.afajof.org/afa/all/presadd2003.pdf> ("Price discovery involves the incorporation of new information into asset prices"); *Price Discovery Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/pricediscovery.asp#axzz1ijG6RcN3> ("[Price discovery is a] method of determining the price for a specific commodity or security through basic supply and demand factors related to the market. . . . For example, if the demand for a particular commodity is higher than its supply, the price will typically increase (and vice versa)."); *Price Discovery*, LONDON METAL EXCHANGE, [http://www.lme.com/price discovery.asp](http://www.lme.com/price%20discovery.asp) ("The most reliable prices in any market are derived from those where the greatest concentration of trading takes place.").

⁹⁴ Lawrence B. Patent & Charles R. Mills, *CFTC Proposes Energy Related Position Limits*, K&L GATES LLP (Feb. 2, 2010), <http://www.klgates.com/newsstand/detail.aspx?publication=6182>. Regarding the term "price discovery":

[O]ne of the main goals of the futures markets is price discovery. The futures markets are responsible for discovering the true price of commodities. With the use of open outcry to bid for contracts, the true value of commodities is discovered in the pits of the nation's futures exchanges. A market that allows one person to determine allocation cannot be engaged in legitimate price discovery because an individual, not the market, is determining allocation;

V. Leelakumar Peesapati, *Freedom of Markets or License to Loot: Proposed Commodity Futures Trading Commission Regulation 1.35*, 8 ADMIN. L.J. AM. U. 97, 118-19 (1994) (internal citations omitted).

⁹⁵ Patent & Mills, *supra* note 94.

⁹⁶ See McArdle, *supra* note 83 ("I'm opposed to a bill that does 'sensible' things like regulating position limits They are aimed at hedge funds betting on the future price of oil. Those bets provide the market with valuable information: a lot of people think that the price of oil is going to go up.").

⁹⁷ See *id.* ("The effect of that information is to raise the future price, which makes current consumers unhappy. But in fact, if the speculators are right, they're doing us a service by giving us a basically gradual price rise that helps us conserve.").

the asset.⁹⁸

This argument was originally made in the context of a significant rise in oil prices which took place in 2007 and 2008,⁹⁹ and most apparently impacted consumers by raising the price of gasoline for their cars.¹⁰⁰ Critics of position limits stated that the increase in gas prices would induce consumers to adjust their consumption habits, which might be demonstrated in different decisions such as reduced consumption or car manufacturers designing cars to be more fuel efficient.¹⁰¹ Had that price increase not taken place gradually and early on, if and when a real oil shortage occurred, consumers would have taken no action to adjust their consumption would be worse off, facing a sudden change rather than a gradual one.¹⁰²

Interestingly, the same argument might apply to CDSs, particularly in the context of “naked” CDSs, in which the protection buyer does not own the reference obligation.¹⁰³ Some have argued that the trading of naked

⁹⁸ See *id.* (“If [speculators] are on the money, and Congress chases them out of the market, we’ll suffer more later, wishing all the while that we hadn’t used the stuff so profligately.”). Note that this viewpoint is in conflict with the assertion that excessive speculation creates artificially high or low prices, which do not express the true value of the commodity. See *supra* note 84 and accompanying text.

⁹⁹ During the “oil shock” of 2007 and 2008, oil reached \$145 per barrel in July 2008, followed by a sudden and drastic price collapse. James D. Hamilton, *Causes and Consequences of the Oil Shock of 2007-08*, abstract, 1, available at http://www.brookings.edu/economics/bpea/~media/Files/Programs/ES/BPEA/2009_spring_bpea_papers/2009_spring_bpea_hamilton.pdf. See McArdle, *supra* note 83 and accompanying text. See also Brad Plumer, *Are Speculators to Blame for Soaring Gas Prices?*, THE WASHINGTON POST, (Mar. 5, 2012), http://www.washingtonpost.com/blogs/wonkblog/post/are-speculators-to-blame-for-our-gas-price-woes/2012/03/05/glQAqMS8sR_blog.html (discussing oil speculation and noting that “many economists argue that this type of speculation can serve a legitimate purpose. ‘If there’s a risk of a supply disruption in the future, then we’d want to store a little more oil right now so that we had that contingency for later If we were right to be worried, it will turn out to be a good thing.”).

¹⁰⁰ See *How Gas Prices Work*, HOW STUFF WORKS, <http://auto.howstuffworks.com/fuel-efficiency/fuel-consumption/gas-price.htm> (last visited Mar. 10, 2011) (discussing the relationship between the prices of oil and gasoline, and the related effect on consumers). See also McArdle, *supra* note 83 and accompanying text; Plumer, *supra* note 99 and accompanying text.

¹⁰¹ See McArdle, *supra* note 83 (“[I]f the speculators are right, they’re doing us a service by giving us a basically gradual price rise that helps us conserve If they’re wrong, later we’ll have cheap gas and more fuel efficient cars, hardly a tragedy.”).

¹⁰² See *id.* (“If [speculators] are on the money, and Congress chases them out of the market, we’ll suffer more later, wishing all the while that we hadn’t used the stuff so profligately.”). Restated, the argument of these critics seems to be that consumption is dictated by market price; if market price remained artificially low because of position limits and consumption remained unadjusted, then when a price correction occurred to reflect scarcity of oil, consumption, expressed through gas consumption and fuel-efficient cars, would have to rapidly correct, as opposed to a gradual change taking place as the price of oil climbed steadily as a result of speculation. See also Plumer, *supra* note 99 and accompanying text.

¹⁰³ Sam Jones, *The Benefits of Naked CDS*, ALPHAVILLE (Mar. 2, 2010), <http://ftalphaville.ft.com/blog/2010/03/02/161556/the-benefits-of-naked-cds/> (defining naked CDSs as those in which “CDS positions [are] taken by investors who do not own the underlying bond to which the contract refers”).

CDSs can drive down the value of the reference obligation (i.e., a company's debt, whether a loan or bond) because the CDS gives the reference obligation the appearance of being less creditworthy.¹⁰⁴ However, there is also an argument to be made that the market's decision to trade such that the value of this debt decreases, reflects the true creditworthiness of the company, thereby providing potential lenders with an opportunity to adjust their behavior vis-à-vis this company accordingly, whether by lending on less favorable terms, taking more collateral, etc.¹⁰⁵

Regardless of arguments made for and against the use of position limits,¹⁰⁶ market participants generally seem to agree that at least some limit on the size of a position that may be held should be in place because of the limit it places on excessive speculation.¹⁰⁷ Thus, the issue becomes not one of whether to have the limits at all, but rather what those limits should be, keeping in mind the need to protect participants from excessive speculation and balancing that need with the goal of not harming liquidity

¹⁰⁴ See Charles Davi, *Derivative Dribble, Naked CDS: Exposed* (Aug. 10, 2009), <http://derivativedribble.wordpress.com/2009/08/10/naked-cds-exposed/>, which compares naked CDS trading to trading unhedged put options, a practice which has met with no negative press despite its similarity to the use of naked CDSs. Buying CDS protection expresses a "negative view on" the creditworthiness of a borrower because the buyer anticipates that the borrower will not be able to repay its obligation. *Id.* See also Anu Munshi, *Structured Credit Investor, Banning Naked CDS Shorts: A Bridge Too Far* (Mar. 15, 2011), available at <http://www.bandstructuredfinance.com/documents/BanningnakedCDSshortsabridgetoofarSCIMarch2011.pdf> (stating that "[w]e've read the widespread criticism of naked short selling via CDS and how it can push corporates and sovereigns into default or a web of spiraling cost of debt. Widening CDS spreads can cause cashflow problems for issuers by increasing their cost of financing.").

¹⁰⁵ See generally John Hull et al., *The Relationship Between Credit Default Swap Spreads, Bond Yields, and Credit Rating Announcements* 6-7 (2004), <http://www.rotman.utoronto.ca/~hull/DownloadablePublications/HPWPaperonCDSSpreads.pdf> (discussing the relationship between CDS spreads and bond ratings, and particularly relevant here, the extent to which a change in the CDS spread of a bond precedes a similar change in its rating). See also Munshi, *supra* note 104 (arguing that "[b]anning naked CDS shorts isn't a good move for a variety of reasons. The CDS price of an issuer tells you about the market perception of its creditworthiness. . . . Barring naked CDS shorts will constrain a fully functioning two-way credit market and reduce the reliability of an important market barometer.").

¹⁰⁶ See Allen Sykora, *Analysts: Position Limits Could Reduce Liquidity In U.S. Commodity Futures Markets*, KITCO NEWS, (Jan. 26, 2011) <http://community.nasdaq.com/News/2011-01/analysts-position-limits-could-reduce-liquidity-in-us-commodity-futures-markets.aspx?storyid=55534> (quoting several industry analysts on their opinions regarding the imposition of position limits on the energy markets by the federal government). See also Munshi, *supra* notes 104-05.

¹⁰⁷ See, e.g., Yahoo! Answers, *What is meant by "Market Wide Position Limit" in derivatives?*, <http://answers.yahoo.com/question/index?qid=20080825193742AAoFAsx> (last visited Mar. 10, 2011) (noting that position limits are important because they limit counterparty risk that a party on one side of a trade will not be able to cover its losses and because they prevent derivatives trading from unduly influencing the price of the underlying asset). Cf. Michael W. Masters & Adam K. White, *The Accidental Hunt Brothers: How Institutional Investors Are Driving Up Food and Energy Prices* (July 21, 2008), available at <http://www.loe.org/images/content/080919/Act1.pdf> (asserting that Congress should impose more stringent position limits on commodities "[t]o repair the damage to the price discovery \ function and to bring food and energy prices down to levels that more accurately reflect supply and demand").

or unnecessarily passing transaction costs along to end-users.¹⁰⁸ The following subsection examines a position limit scheme for commodity derivatives that was recently proposed by the CFTC.

B. Recently Proposed Position Limits on Physical Commodities

Earlier this year, the CFTC “issued proposed rules . . . that establish position limits and limit formulas for twenty-eight physical commodity¹⁰⁹ futures and option contracts and physical commodity swaps that are economically equivalent to such contracts.”¹¹⁰ These limits were proposed pursuant to Title VII of the Dodd-Frank Act, which “requires that the CFTC establish position limits for certain physical commodity and related cash-settled derivatives.”¹¹¹ The setting and implementation of these limits will be gradual and is predicted to culminate in the first quarter of 2012.¹¹² Trying to mitigate some of the concerns described earlier in this Note, the CFTC stated that “[t]he proposed position limits framework would enable the Commission to meet its statutory responsibility for setting limits in order to combat excessive speculation and manipulation while ensuring *sufficient market liquidity* and efficient price discovery.”¹¹³

The implementation process is divided into two phases, with the eventual goal that the CFTC devise its own limits, separate from those previously imposed by exchanges, and to impose those new limits on a spot, single and all month basis.¹¹⁴ “The purpose for this two-step approach is to allow the CFTC enough time to gather data on physical commodity swaps,”

¹⁰⁸ See Pickel & Bentsen, *supra* note 93, at 5 (“We believe it is possible to create a position limit regime that meets the statutory requirements of Dodd-Frank and also serves the needs of the marketplace, but, as our comments indicate, much more work and research need to be done in order to reach the appropriate balance . . . [and] to devise sensible position limit proposals that preserve market liquidity while ensuring that manipulation and excessive speculation are deterred.”).

¹⁰⁹ According to the CFTC, “28 specific [previously] exempt and agricultural commodities are covered by the proposed regulations. [Previously] [e]xempt commodities broadly include, but are not limited to, gold, silver, copper, platinum, palladium, crude oil, natural gas, heating oil, and gasoline. Agricultural commodities broadly include, but are not limited to, corn, oats, rice, soybeans, soybean meal, soybean oil, wheat, feeder cattle, live cattle, lean hogs, milk, cocoa, coffee, orange juice, sugar, and cotton.” *Commodity Futures Trading Commission, Office of Public Affairs, Q & A – Position Limits for Derivatives* 1 (2011), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pl_qa.pdf.

¹¹⁰ Stroock & Stroock & Lavan LLP, *CFTC Issues Proposed Regulations Regarding Position Limits for Derivatives* 1 (Feb. 28, 2011), <http://www.stroock.com/SiteFiles/Pub1041.PDF> (citing Position Limits for Derivatives, 76 Fed. Reg. 17 (Jan. 26, 2011), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-1154a.pdf>).

¹¹¹ Stroock & Stroock & Lavan LLP, *supra* note 110, at 2.

¹¹² See *id.*

¹¹³ *Commodity Futures Trading Commission, supra* note 109, at 1 (emphasis added).

¹¹⁴ See Stroock & Stroock & Lavan LLP, *supra* note 110, at 2. For explanations of spot, single and all-month bases, refer to *supra* note 89 and accompanying text.

which it was previously unable to do “under the Commodity Futures Modernization Act of 2000.”¹¹⁵ Because spot month data is based on the estimated deliverable supply, whereas data for the physical swap market has not yet been collected, “the Commission can implement spot-month limits relatively expeditiously in the initial transitional phase while waiting to receive the necessary data to implement non-spot-month limits in the second phase.”¹¹⁶

Presently, the CFTC has proposed separate formulas and methods of calculating positions, depending on whether the limit is for a spot month.¹¹⁷ Spot month limits will be set at 25% of the estimated spot month deliverable supply, with an exception for up to five times that amount as long as the position does not exceed the single month limit and the trader’s position is solely in cash-settled contracts.¹¹⁸ The non-spot month limits will be calculated based on the open interest¹¹⁹ of the particular contract, with limits for each contract and class of contract.¹²⁰ Contracts of the same class would be combined and netted together to determine the trader’s single and all month positions for that particular class.¹²¹

This Note’s proposal for position limits on CDSs¹²² and that of the CFTC for physical commodity derivatives are consistent on a number of

¹¹⁵ *Id.*

¹¹⁶ *Commodity Futures Trading Commission, supra* note 109, at 2.

¹¹⁷ *See id.* at 1.

¹¹⁸ *See id.* Note that physical settlement means that under the terms of the contract, whether a future, forward, or option, the parties have a right or obligation to physically deliver or receive the underlying commodity. *See Physical Settlement, Cash Settlement*, <http://www.riskglossary.com/link/physical%20settlement.htm> (last visited Mar. 10, 2011). Contrast this to a cash settlement, which would most likely include commodity swaps, in which the parties make cash payments based on the value of the underlying commodity. *See id.* For an example of “deliverable supply,” refer to *supra* note 85 and accompanying text.

¹¹⁹ Open interest means “[t]he options or futures contracts that an investor has not closed and that have not matured or expired. For example, if an investor buys 10 futures contracts on Monday, and sells six on Wednesday, the investor has an open interest of four at the end of the trading day on Wednesday. It should not be confused with the trading volume for an option or futures contract.” THE FREE DICTIONARY, *Open Interest*, <http://financial-dictionary.thefreedictionary.com/Open+Interest> (last visited Mar. 10, 2011). More simply stated, it is “[t]he number of contracts for particular futures or an option which, at a given time, are outstanding.” *Id.* Contrast this with “trading volume,” which is “[t]he measure how many trades take place for a security or on an exchange on a given trading day.” THE FREE DICTIONARY, *Trading Volume*, <http://financial-dictionary.thefreedictionary.com/Trading+Volume> (last visited Mar. 10, 2011).

¹²⁰ *See Stroock & Stroock & Lavan LLP, supra* note 110, at 3. *See also Commodity Futures Trading Commission, Q & A – Position Limits for Futures and Swaps 2*, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pl_qa_final.pdf (explaining that “[o]pen interest used in determining non-spot-month position limits will be based on futures open interest, cleared swaps open interest, and uncleared swaps open interest.”).

¹²¹ *See Stroock & Stroock & Lavan LLP, supra* note 110, at 4. *See also Q & A – Position Limits for Futures and Swaps, supra* note 120, at 2 (stating that “[t]he non-spot-month position limits apply to positions a trader may have in all contract months combined or in a single contract month.”).

¹²² *See generally infra* conclusion.

points. While this Note proposes a net notional-based calculation for determining a trader's true position, the CFTC proposal nets together long and short (i.e., buy and sell) positions of contracts.¹²³ Using number of contracts as the unit of measurement in the case of physical commodities, as opposed to net notional, makes sense because exchange-traded commodity contracts have identical, uniform size, and even an OTC derivative based on a physical commodity could likely be converted into an equivalent number of contracts for the purpose of determining the size of the position.¹²⁴ While not completely analogous, the change in limits based on the month and the deliverable supply of the underlying commodity shows a degree of flexibility of the limits, which is also suggested in this proposal.¹²⁵ Finally both frameworks identify the need for additional work done in this area, particularly the need for further research regarding liquidity concerns as a result of position limits.¹²⁶

C. Proposed Position Limit Scheme for CDSs

This Note presents a rough framework for position limits on CDSs that facilitate widespread use, emphasizing mindfulness of maintaining liquidity in the CDS and related debt markets, while providing an adequate safeguard against multilateral default in the event of another credit crisis.¹²⁷

The crux of this proposal is to limit positions of CDSs for a particular reference obligation based on net notional (as opposed to net number of contracts), as CDSs are not traded in uniform contract sizes, making them quite distinct from exchange-traded futures and options contracts.¹²⁸ As discussed, the traditional implementation of position limits in the commodity markets has been as a maximum number of options or futures

¹²³ Compare *supra* note 121 and accompanying text with *infra* notes 128-30 and accompanying text.

¹²⁴ See *supra* note 123 and accompanying text.

¹²⁵ Compare *supra* notes 117-21 and accompanying text with *infra* notes 135-38 and accompanying text.

¹²⁶ See *infra* notes 139 and accompanying text.

¹²⁷ See generally Pickel & Bentsen, *supra* note 93, at 5. See also CME GROUP, *Excessive Speculation and Position Limits in Energy Derivatives Markets* 7 (2009), <http://www.cmegroup.com/company/files/PositionLimitsWhitePaper.pdf>.

¹²⁸ See generally *Difference Between OTC and ET Derivatives*, CONTRARIAN INVESTORS' JOURNAL, (May 1, 2008), <http://cij.inspiring.com/?p=433> (discussing the difference between OTC and exchange-traded products, and noting that while exchange-traded contracts are standardized, OTC contracts are privately negotiated between the parties and are "tailor-made to the two parties' liking"). See also *Credit Default Swap (CDS) Primer* 3 (May 12, 2004), http://www.securitization.net/pdf/content/Nomura_CDS_Primer_12May04.pdf (noting that "[t]here are no limits on the size or maturity of CDS contracts. However, most contracts fall between \$10 million to \$20 million in notional amount.").

contracts that a trader could hold at a given time.¹²⁹ This Note proposes that position limits on CDSs should be implemented based on a maximum net notional, either for a specific reference obligation, or for similar types of reference obligations, which would share similar characteristics and thus have approximately equivalent credit risk for the parties involved. It might also be possible to create a scheme of position limits which combines aspects from both of those calculation methods.

What does it mean to calculate a position based on net notional? Assume that a bank executes a CDS in which it sells protection on a particular reference obligation. The notional of the first CDS was \$100 million. That same bank then executes a CDS in which it buys protection on that same reference obligation and the notional of the second CDS is \$90 million. Assuming all other factors are equal, such as tenor, fixed interest rate, etc., the bank has a net CDS position for that particular reference obligation of \$10 million. The protection buy and sell go in opposite directions. The sell is \$100 million and the buy is \$90 million; when those two amounts are netted together, because they have opposite signage, the net amount is \$10 million, specifically a net sell of \$10 million.¹³⁰

The advantage of this method of calculating the position limit is that it does not penalize the bank for doing a large volume of business¹³¹; rather, because the bank knows ahead of time what its position limits are, there is an incentive for the bank to adequately hedge its positions (i.e., execute trades that reduce its net position). The bank is still able to make a market in CDSs for a given reference obligation, which across a large number of buyers and sellers equates to liquidity in the CDS market as a whole, and by encouraging the bank to hedge its CDS position, there can presumably be spill-over liquidity into other markets, if non-CDSs are used to hedge and offset the position.¹³² Thus, in the previous example, the bank could

¹²⁹ See *supra* notes 79-80 and accompanying text.

¹³⁰ See generally International Swaps and Derivatives Association, Inc., *Top 10 CDS Positions*, CDS MARKETPLACE (Mar. 5, 2011), http://www.isdacdsmarketplace.com/exposures_and_activity/top_10_cds_position.

¹³¹ If position limits were calculated on a gross notional or number-of-contracts basis, using the example in the text, the bank would have a gross CDS position of \$190 million, as opposed to true net exposure of \$10 million. See *id.* Net notional gives a clearer picture of what the bank's exposure to credit risk for the reference obligation, whereas gross notional ignores the directionality of having either bought or sold protection. See Eric J. Peterman et al., *supra* note 70 (observing that "[i]t would seem rather odd to aggregate on a gross basis—and subsequently set position limits—because market participants may, for example, carry CDS merely to hedge reference obligations they hold.").

¹³² See Sykora, *supra* note 106 (quoting futures trading strategist Charles Nedoss as saying, "To me, the more players who are in the market, the more liquidity in the market."). The bank would likely be encouraged to hedge its CDS positions with other securities because doing so would permit it to buy or sell additional CDS contracts, since the better hedged a position, the less impact it has on making the bank reach its position limit. Furthermore, if active trading and large numbers of buyers and sellers

hedge the first \$100 million notional CDS by taking a short position a certain number of bonds issued by the reference entity. While a credit event might trigger the bank's obligation to pay under the terms of CDS, the money made in the short position when the bond price decreased would at least partially offset the payment to be made under the CDS contract. Alternatively, the bank could hedge its position by purchasing an option to enter into an offsetting CDS referencing the same obligation. Either of these scenarios, multiplied across several CDS market participants, would increase liquidity in related debt and/or option markets, benefitting not only the business whose borrowing activity is facilitated by the availability of CDSs, but market participants universally, at least across related asset classes.¹³³

equate to liquidity, then banks going into other markets to hedge their CDS positions would equate to "spill-over liquidity" in those related markets.

¹³³ There are likely two main concerns about implementing this position limit scheme: operational difficulty, which might include record keeping and other procedural requirements (e.g., real-time systems to ensure that a bank or other CDS user does not exceed its position limit); and the increased transparency requirements, as there would need to be greater disclosure in order to effectively utilize a dynamic position limit scheme that could be readily adjusted based on different criteria. New regulations, such as those regarding position limits, "establish[] record-keeping and reporting requirements for swap dealers and major swap participants, and . . . prescribe which records must be maintained by swap dealers and major swap participants." Johnny Lee, *Dodd-Frank Act Creates New Record-Keeping Requirements for Commodities Traders*, FORENSIC UPDATE (Feb. 8, 2011), <http://forensicupdate.wordpress.com/2011/02/08/dodd-frank/>. These "new rules regarding the derivatives market, [mean that] many companies are unsure how much the regulatory overhaul will end up costing them." *Cost of Dodd-Frank Compliance Remains Shadowy*, FINCAD (Dec. 21, 2010), <http://derivative-news.fincad.com/derivatives-regulations/cost-of-dodd-frank-compliance-remains-shadowy-994/>. Even companies other than financial services firms, such as "[t]ransportation companies and food producers – which use derivative contracts for hedging purposes – will also be affected by the legislation." *Id.* Generally speaking, "[c]ompanies subject to the [Dodd Frank] Act, would be required under the proposed . . . rules to maintain full and complete transaction and position information for all swap activities." Lee, *supra*. Similar to observations made regarding accounting reform under Sarbanes-Oxley, while possibly painful in the short-term, both in terms of cost and implementation, "if there's an improvement in confidence by the market, improvement of the veracity of financial info, etc., then any costs will be worth it." Jill M. D'Aquila, *Tallying the Cost of the Sarbanes-Oxley Act* (Nov. 2004), <http://www.nysscpa.org/cpajournal/2004/1104/perspectives/p6.htm> (emphasis added) (internal quotations omitted). Simply stated, it is an upfront cost now that is necessary to reduce the possibility of a (far more costly) financial catastrophe in the future. Regarding the need for increased transparency, there may be some backlash as "Wall Street firms' tend[] to hoard information about markets and how they make money." Bradley Keoun, *Trading Eludes Dodd-Frank as Investors See Black Box*, BLOOMBERG (Sep. 12, 2010), <http://www.bloomberg.com/news/2010-09-12/trading-eludes-dodd-frank-as-no-investors-see-inside-black-box.html>. Critics of this "black box" mentality point out that "[i]f there's one thing we've learned from the financial crisis, it's that a lack of transparency is absolutely devastating . . . [and that] [o]pacity also . . . contributed to a loss of confidence in the banks." *Id.* (internal quotations omitted). However, financial services firms seem to have recognized, on their own, the need for increased transparency in light of the latest financial crisis. "Citigroup CEO Vikram Pandit . . . said that 'markets cannot function without transparency' and that improved disclosure . . . would help 'revive and sustain confidence in our financial system.'" *Id.* "Tanya Azarchs, former head of North American bank research at Standard & Poor's" recently noted that "[t]he health of the banking system impinges on all areas of the economy . . . [s]o their disclosure has to be top-notch." *Id.* Towards that end, "a group of 17 banks have come together to create a clearinghouse system to move credit default swap[s] and cover a failure by one of the market-makers." David Enke, *Central CDS Clearinghouse* (June 12, 2008), <http://seekingalpha.com/article/80984-central-cds-clearinghouse>. A clearinghouse is

Finally, aided by the other regulatory innovations under Dodd-Frank,¹³⁴ regulators should strive to make the actual size of the limits as dynamic as possible, such that the CDS and debt markets are not harmed by illiquidity. The means to ensure continued availability of financing for small businesses is in the increased market transparency facilitated under this statute.¹³⁵ Regulators should determine specific limits based on the credit risk component of the reference obligation, perhaps using ratings provided by credit rating agencies¹³⁶ as a metric. Additionally, regulators must be cognizant of the fluid nature of CDS market participants' financial health, perhaps using net capital¹³⁷ as a measure of a party's ability to incur credit

"[a]n agency or separate corporation," which is generally part of an exchange, that is "responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery and reporting trading data. Clearing houses act as third parties to all futures and options contracts - as a buyer to every clearing member seller and a seller to every clearing member buyer." *Clearing House*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/clearinghouse.asp> (last visited Mar. 12, 2011); see also *What's a Clearinghouse?*, THE ECONOMIST (Apr. 22, 2010), <http://www.economist.com/blogs/freeexchange/2010/04/derivatives>; International Swaps and Derivatives Association, Inc., *How Do Cleared Derivatives Differ From OTC Derivatives?*, <http://www.isda.org/educat/faqs.html> (last visited Oct. 18, 2013). "ICE Trust LLC" is currently "the largest U.S. clearinghouse for credit default swaps." Silla Brush, *Wall Street's 'Derivatives Dealers Club' May Break Up* (Feb. 7, 2011), http://thejavelin.com/index.php?option=com_content&view=article&id=149:bn-wall-streets-derivatives-dealers-club-may-break-up-&catid=1:latest-news. Two significant "benefits of the clearinghouse will be increased liquidity and transparency." *Id.* "Currently, it is difficult for companies to even know what their credit risk exposure is given that the CDS market is thin and delayed, not to mention opaque at best. The new [clearinghouse] system is a good step towards helping to shine light on the CDS market by reducing credit risk, and allowing for more real-time price discovery." *Id.* Thus, while secrecy regarding trading activity may have traditionally been the status quo on Wall Street, it seems that both regulators and CDS market participants are taking serious steps to increase market transparency, which means the response to report requirements under this proposed position limit scheme are likely to be less negative than one might expect.

¹³⁴ Dodd-Frank creates vastly increased oversight in the residential lending market to prevent widespread predatory lending practices, which is essential for the survival of the secondary loan market, which in turn goes hand-in-hand with the securitization industry. See generally §§ 1400-1498, 124 Stat. at 2136-2212. Increased transparency for dealers and traders of CDSs is certainly essential: the situation should not arise whereby regulators are struggling to determine a party's CDS exposure. Dodd-Frank, through the advent of reporting and documentation requirements, as well as the establishment of swap exchanges on which previously OTC-traded derivatives will now clear, implements an overall strategy that will enhance the clarity and disclosure with which this market operates. See e.g., § 729, 124 Stat. at 1701-02; see also §§ 723, 733-34, 124 Stat. at 1675-82, 1712-18. Additionally, Dodd-Frank implements new requirements for adequate capitalization, margin and collateral, and the use and regular review of risk models, as part of the daily operations of the newly created derivatives exchanges. See e.g., §§ 725, 731, 736, 763, 124 Stat. at 1688, 1705, 1722, 1775-78.

¹³⁵ See *id.*

¹³⁶ See Jonathan Katz, et al., *Credit Rating Agencies: No Easy Regulatory Solutions, Crisis Response* (Oct. 2009), available at <http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf> ("A credit rating is an opinion on the creditworthiness of a debt issue or issuer."); see also Denise Finney, *A Brief History of Ratings Agencies*, <http://www.investopedia.com/articles/bonds/09/history-credit-rating-agencies.asp#axzz1isYMFj8I>.

¹³⁷ *Net Capital*, http://www.investorwords.com/3238/net_capital.html (last visited Mar. 10, 2011), which defines "net capital" as "[a] firm's net worth, minus deductions taken for any assets that might not easily be converted into cash at their full value." The greater the trader's net capital, presumably the greater the ability of that trader to repay its obligations under CDS contracts and, thus, the greater

risk through trading CDS contracts. A combination of these and other quantitative and qualitative factors should be included in the calculus to determine how much credit exposure a buyer or seller may safely incur at a given time, balancing the need to maintain liquidity with the objective of reducing incidents of counterparty default in CDS transactions.¹³⁸

Whatever limits regulators devise, those limits should be rolled out gradually, similar to the enactment period discussed in the most recent CFTC proposed rule on position limits for physical commodities. Gradual implementation diminishes the likelihood that reactionary trading would take place, as traders attempted to reduce their positions to meet regulatory requirements.¹³⁹

Perhaps most critical, is the need for frequent and honest dialogue and disclosure between regulators and market participants, which promotes the widespread dissemination of information, thereby maintaining liquidity

his or her ability to incur credit risk. This is similar to Rule 15c3-1 of the Securities Exchange Act of 1934 (i.e., the “Net Capital Rule”), which “requires broker-dealers to maintain ‘net capital’ (net worth adjusted by certain deductions for illiquid assets and reserves against possible market losses on securities positions) such that the liabilities incurred by the broker-dealer (its ‘aggregate indebtedness’) does not exceed a certain percentage of the broker-dealer’s net capital or of a specified percentage of the aggregate of transactional moneys owed to the broker-dealer by customers (its ‘aggregate debit items’).” Municipal Securities Rulemaking Board, *Net Capital Rule*, http://www.msrb.org/msrb1/glossary/view_def.asp?param=NETCAPITALRULE (last visited Mar. 10, 2011). Under this rule, “[b]roker-dealers are required to suspend or terminate their securities activities if they are unable to meet this test.” *Id.*

¹³⁸ Providing separate sets of limits for spot and non-spot months is not relevant to CDSs as there is no uniform rule requiring physical delivery or receipt of the reference obligation imbedded in the terms of the contract. See Michiko Whetten, et al., *Credit Default Swap (CDS) Primer 4* (May 12, 2004), available at http://www.securitization.net/pdf/content/Nomura_CDS_Primer_12May04.pdf (“The first step taken after a credit event occurs is a delivery of a ‘Credit Event Notice,’ either by the protection buyer or the seller. Then the compensation is to be paid by the protection seller to the buyer via either (1) physical settlement, or (2) cash settlement, as specified in the contract.”); see also Mary Brown, *Credit Default Swaps: What Happens In A Credit Event?*, <http://www.investopedia.com/articles/bonds/09/what-happens-to-single-name-cds.asp#axzz1isYMFj8I> (last visited Oct. 18, 2013) (noting that the parties to the CDS can choose between either cash or physical settlement).

¹³⁹ See Sykora, *supra* note 106 (“As an example of what happens when rules push some out of positions, [Spencer Patton] cites the steep one-day sell-off that occurred in silver futures in 2010 when CME Group raised margin requirements.”). Additionally, and also similar to the recent CFTC proposal, regulators should schedule a period of research and information gathering, during which time resources are dedicated towards analyzing potential effects of decreased liquidity in the CDS markets. See Stroock & Stroock & Lavan LLP, *supra* note 110, at 2 (“The purpose for this two-step approach is to allow the CFTC enough time to gather data on physical commodity swaps.”). Because of the relationship and possible impact on the U.S. lending economy, careful attention should be paid to the relationship between CDS liquidity and financing cost and availability. Businesses that are sensitive to changes in financing availability, particularly small businesses, could be harmed if a decrease in CDS liquidity negatively impacted their ability to borrow. See *supra* note 11 and accompanying text. While this Note sought to provide a series of analyses to demonstrate the existence of such a relationship, and thus the importance of maintaining CDS liquidity, there appears to have been no empirical studies done which link CDS liquidity specifically with small business lending. See generally *supra* Section III. Further study in this area, as part of this proposed position limit scheme, would help mitigate any possible future harm to small businesses.

through rapid and dynamic changes in position limits as market conditions dictate.

CONCLUSION

CDSs permit lenders to exchange what might otherwise be prohibitive credit risk,¹⁴⁰ increasing the likelihood that they will lend,¹⁴¹ which in turn increases the availability of financing for businesses,¹⁴² and thus, the chance that those businesses will be able to remain solvent over longer periods of time.¹⁴³ Liquidity in the CDS markets facilitates lending, in turn, by increasing liquidity in the debt markets.¹⁴⁴ Businesses, particularly small and newer businesses, require financing to continue operations due to uncertain or inadequate cash flows.¹⁴⁵ The relationship between the continued success of these businesses and liquidity in the CDS markets seems clear: CDSs permit otherwise risk averse lenders to reduce credit risk and thus lend more favorably,¹⁴⁶ and the existence of sufficient debt financing equates to continued and healthy operations of the businesses in question.¹⁴⁷

The need to guard against excessive speculation generally and in the CDS market is widely recognized.¹⁴⁸ Thus, it seems inevitable that position limits on CDSs will be imposed in the near future. The key is to devise a position limit scheme that is not overly restrictive and ensures continued liquidity in the CDS markets.¹⁴⁹ That liquidity spills over into the lending markets, which in turn means more lending to more businesses.¹⁵⁰ The proposed position limit scheme in this Note utilize net notional-based position calculations and aggregation of CDSs and related hedges, to ascertain the most accurate view of a market participant's position at a given time.¹⁵¹ By ensuring that limits are dynamic, such that they can be readily adjusted depending on market conditions, and by continuing

¹⁴⁰ See *supra* note 17 and accompanying text.

¹⁴¹ See *supra* note 37 and accompanying text.

¹⁴² See *id.*

¹⁴³ See *supra* note 11 and accompanying text.

¹⁴⁴ See *supra* note 36 and accompanying text.

¹⁴⁵ See *supra* note 11 and accompanying text.

¹⁴⁶ See *supra* note 55 and accompanying text.

¹⁴⁷ See *supra* note 11 and accompanying text.

¹⁴⁸ See *supra* note 2 and accompanying text.

¹⁴⁹ See *supra* note 113 and accompanying text.

¹⁵⁰ See *supra* notes 36-37 and accompanying text.

¹⁵¹ See generally *supra* Part IV.

research and active dialogue between regulators and market participants,¹⁵² it is likely that the CDS markets will continue to operate as usual and commercial lending will be similarly unimpaired.¹⁵³

CDSs play a critical role in today's credit economy.¹⁵⁴ The ability to obtain financing drives business and innovation to new levels; the CDS protects the lender that supports those businesses, and in doing so, plays a vital role in protecting the economy as a whole.

¹⁵² *See id.*

¹⁵³ *See supra* notes 36-37, 113 and accompanying text.

¹⁵⁴ *See supra* note 41-42 and accompanying text.

