REGULATING THE SWAPS MARKET AFTER THE DODD-FRANK ACT: IN AN ECONOMIC CRISIS, IS REGULATION ALWAYS THE ANSWER?

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"[T]he savings of many years in thousands of families are gone. More important, a host of unemployed citizens face the grim problem of existence and an equally great number toil with little return . . . . Primarily this is because the rulers of the exchange of mankind's goods have failed, through their own stubbornness and their own incompetence . . . . [T]here must be an end to speculation with other people's money . . . ."

–President Franklin D. Roosevelt, Inaugural Address.[1]

"More than 8 million people have lost their jobs. Countless small businesses have had to shut their doors. Trillions of dollars in savings have been lost . . . . And that crisis was born of a failure of responsibility—from Wall Street all the way to Washington . . . . [R]eform would bring new transparency to many financial markets."

–President Barack Obama, April 22, 2010, Speech in New York City.[2]

I. INTRODUCTION

Two American presidents almost eighty years apart led the nation during great economic difficulties, and their solutions for these nationwide problems were astonishingly similar. The failure of the banks and reliance on the speculators in the 1920s and 1930s caused President Franklin D. Roosevelt to enact an overhaul of financial reform, which regulated banks and the securities markets.[3] During the economic downturn in 2009 and

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1. President Franklin D. Roosevelt, Inaugural Address (Mar. 4, 1933), *available at* http://avalon.law.yale.edu/20th_century/froos1.asp.

2. Remarks at the Cooper Union for the Advancement of Science and Art in New York City, 2010 DAILY COMP. PRES. DOC. 290 (April 22, 2010), *available at* http://www.gpo.gov/fdsys/pkg/DCPD-201000290/pdf/DCPD-201000290.pdf.

3. Arthur Schlesinger, Jr., *The 'Hundred Days' of F.D.R.*, N.Y. TIMES, Apr. 10, 1983, at § 3, *available at* http:www.nytimes.com/books/00/11/26/ specials/

2010, President Barack Obama also supported and enacted an expansive financial reform.[4] As history explains, when the economy is weak, American leaders turn to massive regulation. But, is financial reform always the answer? With regulation comes consequences—consequences that affect the public but are not mentioned in a speech given by the country's leader.

This Note discusses the impact of the Dodd-Frank Act and the regulations affecting speculators in the commodities market, specifically the newly-regulated swaps market. Part II of this Note discusses how the commodities market and how the futures market function. This section specifically discusses the difference between hedgers and speculators. Part III focuses on the historical background of the commodities market and discusses the recent issues including the closing of the Enron loophole, spiking oil prices, and the new administration. Part IV discusses the Dodd-Frank Act, enacted on July 21, 2010, which includes regulation of the swaps loophole. Part V explains requirements posed on the speculators trading in the swaps market, including clearing, trading, reporting, and regulating conduct. This section also concludes that each of these requirements will enable the swaps market to become transparent. Part VI argues that although new regulations will help the swaps market achieve transparency, there will be less liquidity in the market, administrative inefficiencies and large costs to the government, taxpayer, and speculator. Part VII suggests that the actual impact of the Dodd-Frank Act on the market and its participants remains unpredictable due to its many effective dates and future political shifts.

II. UNDERSTANDING THE EXCHANGE

As of today, a commodity is defined as "a series of agricultural products and 'all other goods and . . . all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.'"[5] The commodities market

schlesinger-hundred.html.

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

5. Thomas R. McLean, *Telemedicine and the Commoditization of Medical*

includes exchanges of both futures and option contracts. Originally, the commodities market was a "cash market[] where physical commodities were bought and sold," in real time for a certain price.[6]

Increased volume of trading, however, led buyers and sellers to trade futures contracts.[7] A futures contract is a legal agreement between a buyer and a seller to exchange a commodity or a financial instrument at a specific date in the future for a specified price.[8] The price of the contract is determined at the time the agreement is made.[9] A futures contract is highly standardized regarding the delivery specification.[10] It must include the good, the quantity of the good, the quality of the good, the time of delivery, the location of delivery, and the way the price will be decided.[11] "The only variable is price, which is discovered through the trading process . . . ."[12] The standardized contract for futures makes futures trading extremely efficient[13] because buyers and sellers can easily trade one contract for another and "offset their obligation to deliver or take delivery of the commodity."[14] However, delivery takes place only rarely,[15] and most traders offset their positions before their contracts have expired or the delivery dates pass.[16]

Services, 10 DEPAUL J. HEALTH CARE L. 131, 145 (2007); *see* Commodity Exchange Act, 7 U.S.C. § 1a(4) (2006). This definition has changed through history and may still change with the Dodd-Frank Act. *See infra* Part III.A–B.

6. MARK MELIN & JULIE COLLINS, THE CHICAGO BOARD OF TRADE HANDBOOK OF FUTURES AND OPTIONS 8 (McGraw-Hill 2006).

7. *Id.*

8. *Id.*; JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 4 (4th ed. 2000); ROBERT W. KOLB, FUTURES, OPTIONS, AND SWAPS 3 (Blackwell Publishers Inc., 3d ed. 1999) (1994). The buyer "of a futures contract undertakes to receive delivery of the good and pay for it, while the seller of a futures promises to deliver the good and receive payment." KOLB, at 3.

9. MELIN & COLLINS, *supra* note 6, at 10; KOLB, *supra* note 8, at 3.

10. KOLB, *supra* note 8, at 3.

11. HULL, *supra* note 8, at 20; KOLB, *supra* note 8, at 3; MELIN & COLLINS, *supra* note 6, at 10.

12. MELIN & COLLINS, *supra* note 6, at 10.

13. *Id.* at 12.

14. *Id.* at 11.

15. HULL, *supra* note 8, at 22.

16. MELIN & COLLINS, *supra* note 6, at 11. "Offset in the futures market means taking another futures position opposite and equal to one's initial

The trading process of futures contracts helps the world determine the price of a commodity.[17] It is a continual evaluation of a commodity's supply and demand by buyers and sellers who analyze current situations and project each commodity's future price movements to establish price.[18] However, futures exchanges do not "set" prices.[19]

Buyers and sellers exchanging futures contracts are both hedgers and speculators.[20] The purpose of trading in futures contracts is to regulate the risk of changing prices in the cash markets by hedging.[21] "This risk-transfer mechanism makes futures contracts extremely useful tools for controlling costs and protecting profit margins."[22] A hedger, such as a commercial firm, utilizes this goal by agreeing on a present price of a commodity even though the delivery will not take place until a future date.[23] This contract could eventually hurt or help hedgers, depending on the market; however, merchandisers generally understand how to utilize a loss and hedge that loss for potential profit if their future position is opposite their cash position.[24] "In all hedging strategies," the goal is to "establish[]

futures transaction." *Id.*

17. *Id.* at 4. "By requiring open market bids and offers and disseminating price information to all interested parties, futures and options exchanges give everyone a better understanding of business—and eliminate the risk that comes from not knowing." *Id.*

18. *Id.* at 12.

19. *Id.* "The market price of any given futures contract at any given time represents the sum total of all market data and opinions. In other words, the equilibrium price at any given market moment balances the myriad supply and demand factors driving the market. Futures markets are barometers, not referees. They measure the market's equilibrium price; they do not dictate it." *Id.* at 12–13.

20. *See id.* at 13–16.

21. *Id.* at 13. "When traders purchase a futures contract, they are said to be 'long' and profit when the market moves higher. When traders sell a futures contract, they are said to 'short' and profit when the market moves lower. Shorting in a futures market is much easier than shorting other cash markets, which require the person shorting the market to actually borrow the security or commodity they are shorting to make delivery." *Id.* at 16.

22. *Id.* at 13.

23. *See id.* at 14.

24. *Id.* "For example, suppose a Midwest wheat miller agrees to ship 500,000 pounds of flour in six months to a cookie baker in Minnesota. Both agree on a price today, even though the flour will not be delivered for another

in advance, an acceptable price."[25]

Speculators, on the other hand, "assume the risk hedgers try to avoid."[26] Speculators have no interest in the actual commodity; instead, they buy and sell futures contracts by analyzing supply and demand and predicting its effects on future prices for the sole purpose of gaining a profit.[27] Speculators enhance the futures markets by (1) providing information daily about the impact of current events on a specific commodity's supply and demand; (2) assuming the risk of the other side of hedge trades; and (3) providing liquidity[28] to the market.[29] Without this liquidity, hedgers would cause prices to rise and fall dramatically depending on whether they were buying or selling.[30]

Futures contracts are always traded on an exchange. In the United States, "commodities exchanges are voluntary associations of individuals created to facilitate the buying and selling of specific goods."[31] The Chicago Board of Trade, which began operating in the 1860s, was thought to be the first exchange to trade futures.[32] Now, the trading process has developed into a market where exchanges not only take place on a physical trading floor, but also electronically.[33] Virtual trading

six months. The miller does not own the wheat that will eventually be processed and is concerned that prices will rise during the six month period. To hedge against the risk of rising cash prices, the miller buys wheat futures contracts for delivery in six months. When the time comes to acquire the wheat, cash prices have risen. But futures prices have also increased, driven up by the same economic fundamentals. The miller can then sell two futures contracts with the same expiration as those originally purchased to offset the initial long futures position and earn a profit on the futures transactions. Even though the miller will have to pay more for the cash wheat than was originally planned, the futures market gain largely negates that loss." *Id.*

25. *Id.* at 15.

26. *Id.*

27. *Id.* at 16.

28. "Liquidity is a characteristic of a market to absorb transactions of any size without a substantial change in the price. Liquid markets easily match a buyer with a seller, enabling traders to quickly transact their business at a fair price." *Id.*

29. *Id.*

30. *Id.*

31. McLean, *supra* note 5, at 140.

32. KOLB, *supra* note 8, at 3.

33. MELIN & COLLINS, *supra* note 6, at 10–11.

has created more transparency in the market.[34]

Clearinghouses act as third parties to the buyer and seller in future contract trades.[35] They guarantee the performance of a futures contract.[36] "Clearinghouses settle the accounts of their members, clear trades, collect and maintain margin monies, regulate delivery, and report trading data."[37] Members are liable to the clearinghouse for the trades they make.[38] "To minimize the risk of a contract default . . . exchange clearinghouses require their members to deposit performance bond money called margins . . . ."[39] Thus, margins make leverage possible. "Leverage is the ability of a trader to control large dollar amounts of a commodity with a comparatively small amount of capital."[40] And, "[r]ather than pay[ing] for the full value of the contract . . . futures margin amounts require a trader to post a fraction of those amounts."[41]

Because the options and futures exchanges had these limitations, a new market inevitably formed called the swaps market. "In large part, the swap market has emerged because swaps escape many of the limitations inherent in futures and exchange-traded options markets."[42] "A swap is an agreement between two or more parties to exchange sequences of cash flows over a period in the future."[43] Swaps are desirable because they

34. *Id*. at 19. Transparency is the ability for an order flow to be "open and easily observable." *Id*.

35. *Id*. at 17; *see also* HULL, *supra* note 8, at 26.

36. KOLB, *supra* note 8 at 3; HULL, *supra* note 8, at 26.

37. MELIN & COLLINS, *supra* note 6, at 17.

38. *Id*.

39. *Id*. at 18. Margins are "good faith deposit[s] made by the prospective futures trader to indicate his or her willingness and ability to fulfill all financial obligations that may arise from trading futures." KOLB, *supra* note 8, at 3; *see* MELIN & COLLINS, *supra* note 6, at 18.

40. MELIN & COLLINS, *supra* note 6, at 19.

41. *Id*.

42. KOLB, *supra* note 8, at 5. Parties began trading swap contracts for the first time in the 1980s. HULL, *supra* note 8, at 121. The market for swaps has grown immensely, and "hundreds of billions of dollars of contracts are currently negotiated each year." *Id*.

43. KOLB, *supra* note 8, at 4. "For example, Party A might agree to pay a fixed rate of interest on $1 million each year for five years to Party B. In return, Party B might pay a floating rate of interest on $1 million each year for five

are designed to meet specific or particular interests of a party, unlike instruments traded on an exchange.[44] The counterparties can choose the exact maturity they need rather than searching for an appropriate offering on an exchange, and they can choose the price without the restrictions found in exchange-traded contracts.[45] Additionally, "[b]ecause the market does not operate on an exchange, participants have far greater privacy, and they also escape regulation to a considerable degree."[46] This flexibility makes swaps contracts desirable for parties who are anticipating a trade, as compared to exchange-traded instruments, such as futures and options.[47]

III. REGULATIONS

A. Historic Background of Commodity Regulation

Historically, commodities trading exchanges were regulated by the State.[48] In the 1880s, bucket shops or boiler rooms specialized in trading futures contracts.[49] Boiler rooms attracted traders who were dishonest and acted fraudulently towards their buyers.[50] Individuals who traded in boiler rooms were more like salesmen than actual traders because they had minimum training in securities and rarely had securities licenses.[51] These transactions were kept very private and often resulted in larger

years." *Id.* at 4–5. A swap is specifically defined in the Dodd-Frank Act in § 721. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 721(a), 124 Stat. 1658 (2010) (to be codified at 7 U.S.C. § 1a).

44. KOLB, *supra* note 8, at 5. "If they wish, the potential counterparties can start with a blank sheet of paper and develop a contract that is completely dedicated to meeting their particular needs." *Id.*

45. *Id.*

46. *Id.* This, however, is no longer the case. Swaps are now regulated under the Dodd-Frank Act. *See infra* Part IV-V.

47. KOLB, *supra* note 8, at 5.

48. McLean, *supra* note 5, at 144.

49. *Id.*

50. *See* Lydie Nadia Cabrera Pierre-Louis, *Controlling a Financial Jurassic Park: Obtaining Jurisdiction Over Derivatives by Regulating Illegal Foreign Currency Boiler Rooms*, 8 U.C. DAVIS BUS. L.J. 35, 50 (2007).

51. *Id.*

traders making gains at the expense of smaller traders.[52] In the early twentieth century, some states developed security laws, known as blue sky laws, to control boiler rooms.[53] However, state regulation caused problems only for the states that were required to consider the interests of both the exchanges and the boiler rooms.[54] When the courts ruled consistently in the favor of the exchanges, the federal government was left with no alternative but to create federal regulations pertaining to the commodities markets.[55]

The first congressional act to regulate the commodities market was the Future Trading Act of 1921 (FTA).[56] This Act specifically "prevent[ed] price manipulation, such as excessive speculation in grain prices."[57] The FTA "imposed a tax of 20 cents per bushel on all contracts for the sale of grain for future delivery if the sales were not made through a designated board of trade" created by the Secretary of Agriculture.[58] However, the Supreme Court found the FTA unconstitutional, holding that Congress overextended its taxing power.[59]

After the Supreme Court declared the FTA unconstitutional, Congress immediately passed the Grain Futures Act of 1922 (GFA) in hopes of preventing market manipulation.[60] Under § 5 of the GFA, the boards of trade still had to achieve mandated requirements, and the Secretary of Agriculture still had the right to assign boards of trade as contract markets.[61] However, the GFA altogether prohibited futures trading on unregulated markets instead of using a tax to discourage such conduct.[62] The GFA was very similar to the FTA, but this time the Supreme

52. *Id*.

53. *Id*. at 51.

54. McLean, *supra* note 5, at 144.

55. *Id*.

56. Act of Aug. 24, 1921, ch. 86, 42 Stat. 187, invalidated by Hill v. Wallace, 259 U.S. 44 (1922).

57. Gary Rubin, *CFTC Regulation 1.59 Fails to Adequately Regulate Insider Trading*, 53 N.Y.L. SCH. L. REV. 599, 604 (2009).

58. *Id*. at 605.

59. *Hill*, 259 U.S. at 69–70.

60. *Id*.; *see* Rubin, *supra* note 57, at 605.

61. *Id*.

62. *Id*.

Court upheld the constitutionality of the Act under the Commerce Clause.[63]

In 1936, Congress amended the GFA to create the Commodity Exchange Act (CEA).[64] "Congress wanted to prevent unregistered trading establishments [such as boiler rooms] from using high-pressure manipulative sales tactics to convince small investors to speculate on securities or For[eign exchange] markets without reporting the transactions to a board of trade or organized exchange."[65] To solve this issue, the government used the CEA to restrict futures trading to government-approved contract drafters, such as banks and other institutional investors.[66] Specifically, the CEA expanded the Secretary of Agriculture's authority by requiring brokers to register with the Secretary of Agriculture allowing them to trade in the commodities markets, and the Secretary of Agriculture gained the right to terminate a board of trade's designation as a contract market.[67] Basically, "all domestic contracts of sale of a commodity for future delivery had to be executed on an organized commodities market that had been designated as a contract market under the Commodity Exchange Act."[68] Additionally, "to prevent sudden fluctuations in commodity prices, the Commodity Exchange Commission could set speculative position limits on trading."[69] The CEA extended beyond the commodity of "grain to include cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, and . . . potatoes."[70] Overall, the federal government's interest in regulating commodity

63. *Id.*; Pierre-Louis, *supra* note 50, at 50.

64. *See* Pierre-Louis, *supra* note 50, at 50.

65. *Id.*

66. *Id.* at 51–52.

67. Rubin, *supra* note 57, at 605.

68. Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 389 (2005) (internal quotations omitted). "This meant that subject to limited exceptions, there were no over-the-counter derivatives markets, and futures and commodity options contracts were traded through the facilities of organized and regulated contract markets." *Id.* at 389–90.

69. Rubin, *supra* note 57, at 605–06 (citing Commodity Exchange Act, 7 U.S.C. § 5 (2006)).

70. *Id.* at 606 (citing Commodity Exchange Act, 7 U.S.C. § 3(a) (2006)).

contracts was secured when it first began regulating all the commodity contracts, including both futures and forward contracts.[71]

In the 1970s, the commodities markets changed when the focus of the market went from exclusively trading agricultural products to also trading non-agricultural products.[72] This change likely occurred during this decade for two reasons: (1) the currency exchange system that was linked to the gold standard collapsed and (2) the Chicago Board of Options Exchange (CBOE) was created.[73]

Under the Bretton Woods agreement,[74] the values of world currencies were directly connected to the gold standard.[75] In 1971, President Nixon closed the gold window due to extreme inflation, and while the United States gold reserve prices remained unchanged, Milton Friedman, a Nobel Prize winner, decided to profit from this by speculating in gold.[76] Friedman persuaded the Chicago Mercantile Exchange to create a futures market in which gold could be traded by individuals because Friedman realized that individuals could not buy gold from banks.[77] Thus began the non-agricultures commodities exchanges.[78]

Second, in 1973, the Chicago Board of Trade created the Chicago Board Options Exchange (CBOE), which specialized in options contracts.[79] Options contracts have limited liability and

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71. McLean, *supra* note 5, at 144.

72. *Id*. at 136.

73. *Id*. at 136–37.

74. The Bretton Woods Agreement was an international agreement that established a monetary policy among nations and helped to rebuild nations' financial structures following World War II. Addison Wiggin, *Bretton Woods Agreement*, DAILY RECKONING (Nov. 29, 2006), http://www.dailyreckoning.com.au/bretton-woods-agreement/2006/11/29/. A major policy established within the Bretton Woods Agreement was for nations agreeing to maintain currency at values within a margin close to the monetary worth of gold. *Id*. Also, the Bretton Woods Agreement created the World Bank and the International Monetary Fund. *Id*.

75. McLean, *supra* note 5, at 136.

76. *Id*.

77. *Id*.

78. *See id*. at 136–37.

79. *Id*. at 137.

are "more desirable" to speculators than futures contracts.[80] Again, when a buyer is liable under an options contract, the loss will be the cost of the options contract plus commission and fees; however, in a futures contract, the buyer has a greater burden because he is liable for the whole value of the contract.[81] In the early 1970s, options contracts encouraged many speculators to trade in the commodities markets.[82]

Major problems then arose due to all of these developmental changes of the futures industry.[83] In 1974, Congress enacted the Commodities Futures Trading Commission Act (CFTCA), which amended the Commodity Exchange Act.[84] Within this Act, an independent agency separate from the Department of Agriculture was created: Commodity Futures Trading Commission (CFTC).[85] The CFTC had the exclusive power to regulate the futures market, brokers, and others involved in the commodities markets.[86] This Act also expanded the definition of commodity to include commodities other than agricultural products.[87]

B. Current Times

1. Enron Loophole

The Commodity Futures Modernization Act of 2000 (CFMA) again amended the CEA and was described as a "landmark piece of Federal legislation."[88] James E. Newsome, Ph.D.,[89] the

80. *Id*. at 138.

81. *Id*.

82. *Id*.

83. Pierre-Louis, *supra* note 50, at 52. "For example, sugar fell outside the scope of the CEA and became a self regulated industry. The contract market began to fail, and futures were becoming increasingly critical to the proper pricing of the underlying commodity." *Id.*

84. *See* Commodity Exchange Act, 7 U.S.C. § 1 (2006).

85. *See* 7 U.S.C. § 2(a)(2); Hazen, *supra* note 68, at 388–89; Rubin, *supra* note 57, at 606; Pierre-Louis, *supra* note 50, at 52.

86. Rubin, *supra* note 57, at 603.

87. McLean, *supra* note 5, at 145.

88. *Hearing to Review Reauthorization of the Commodity Exchange Act: Hearing Before the Subcomm. on Gen. Farm Commodities & Risk Mgmt. of the H. Comm. on Agric.*, 110th Cong. 17 (2007) [hereinafter *Review Reauthorization*] (statement of James E. Newsome, Ph.D., President, Chief

President, CEO, and Member of the Board of Directors of the New York Mercantile Exchange, Inc. stated:

> The CFMA also provides a well-considered oversight framework for futures markets that has enhanced the abilities of NYMEX [New York Mercantile Exchange] and the other regulated exchanges to operate in a rapidly changing environment.
>
> The CFMA shifted away from a "one-size-fits-all" prescriptive approach to a more flexible approach that included the use of core principles . . . . In addition, the CFMA strengthened the CFTC's role as an oversight regulator. The CFMA's flexible regulatory framework provides benefits to the marketplace while continuing to ensure confidence in the integrity of futures markets.[90]

However, § 2(h) of the CFMA, known as the "Enron loophole," created much tension throughout the financial world until 2008.[91] The CFMA was passed late in December 2000 during a lame duck session of Congress and adding 262 pages to an 11,000 page bill already on the Senate floor.[92] "Late in the night . . . the

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Executive Officer, and Member, Board of Directors, New York Mercantile Exchange).

89. *Id*. at 15–16. Newsome explained the "Core Principles" as follows: "Congress largely replaced extremely detailed, prescriptive regulation with more broadly structured 'Core Principles' for regulated markets. Under the Core Principles approach, Congress sets broad performance standards that must be met by the regulated entity, while enabling the entity to have flexibility with regard to how it complies with these standards. Thus, the CFMA made clear that regulated DCMs shall have reasonable discretion as to the manner in which they comply with the applicable Core Principles set forth in regulation. As a result of the flexible Core Principles approach to regulation, the Exchange can respond rapidly to changing markets by introducing new risk management products, which benefit a broad spectrum of market participants. Market participants have also benefited from recent increased volume levels at all exchanges, which further emphasizes the exchanges' need to be able to respond quickly to market participants' risk management needs. As a result of Congress' foresight and innovation, such improvements can be implemented, subject to CFTC review and oversight, without protracted approval processes." *Id*. at 18.

90. *Id*. at 15–16.

91. *See infra* text accompanying notes 100–02.

92. *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Energy & Commerce*, 110th Cong. 11 (2007) [hereinafter

word energy was struck from that bill" leaving only agricultural commodities for regulation by the CFTC and not energy commodities.[93] The Enron loophole category was created "to allow commercial participants to trade energy and certain other products in a light-touch regulatory environment. This spurred innovation and competition to the ECM platform, [and it] provided a low cost on-ramp to launch new ideas for contract design and trading methodologies."[94]

One example is the Intercontinental Exchange (ICE) which was originally established as an over-the-counter energy market regulated under the CEA, but, under the loophole, it was considered "an exempt commercial market."[95] Goldman Sachs initially created ICE through this loophole.[96] By 2006, the government realized that "certain ECM energy contracts were performing as virtual substitutes for regulated futures contract[s] and may be serving a significant price discovery role."[97] The CFTC wanted to make changes to the CEA to be able to identify manipulation that occurred on the ECMs with the trading of futures contracts that serve "a significant price discovery function."[98]

Energy Speculation] (statement of Michael Greenberger, Professor of Law, and Director, Center for Health and Homeland Security, University of Maryland).

93. *Id*. Under § 2(h), Exempt Commercial Markets, or commonly known as ECMs, were excused from CFTC regulation. *Id*. at 55 (statement of Thomas F. Lasala, Chief Regulatory Officer, Division of Compliance and Risk Management, New York Mercantile Exchange). ECMs trade from principal to principal, meaning they do not trade through a broker. *Review Reauthorization*, *supra* note 88, at 64 (statement of John M. Damgard, President, Futures Industry Association). ECMs are known as being a "multi-lateral electronic trading facility." *Energy Speculation*, *supra* note 92, at 32 (statement of Laura Campbell, Assistant Manager, Energy Resources, Memphis Light, Gas and Water).

94. *Energy Speculation*, *supra* note 92, at 189 (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission).

95. *Id*. at 88 (statement of Charles A. Vice, President and Chief Operating Officer, Intercontinental Exchange).

96. *Id*. at 115 (statement of Michael Greenberger, professor of law, and Director, Center for Health and Homeland Security, University of Maryland).

97. *Id*. at 189 (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission).

98. *Id*.

A couple of companies "manipulated" the energy market by controlling high volumes of one commodity.[99] First, in the fall of 1999, Enron advanced its position in electricity.[100] It bought a majority of energy contracts provided by West Coast Electricity.[101] And with Enron's collapse, the electric market plummeted.[102] However, Enron requested and proposed to Congress the exemption of over-the-counter electronic exchanges from CFTC regulation for the CFMA in 2001,[103] which inevitably created the Enron loophole.[104] Similarly, in 2004, "British Petroleum acquired ninety percent of all U.S. propane supplies. Once in control of the market, BP intentionally withheld propane from the market and charged buyers artificially inflated prices in a classic supply squeeze. In a . . . [c]ourt settlement, BP . . . agree[d] to pay $303 million in penalties and restitution."[105]

Another example of manipulation occurred in 2006 on the NYMEX and involved natural gas. For most of 2006, Amaranth, a Connecticut-based hedge fund, controlled the natural gas

99. Speculation or even excess speculation does not denote manipulation in the market place. Generally, manipulation is "an illegal act of somebody individually or cooperatively with others trying to game the system for a profit without risk." *Role, Responsibilities, and Resource Needs of the Commodity Futures Trading Comm'n for Oversight of Energy Market and Oil Futures Contracts: Joint Hearing Before the S. Comm. on Agric., Nutrition, & Forestry & the Subcomm. on Fin. Servs. & Gen. Gov't of the S. Comm. on Appropriations*, 110th Cong. 30 (2008) [hereinafter *Role Responsibilities*] (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission). Manipulation is different than upward pressure. *Id.* at 31. The business conduct rules were created for this purpose. *See infra* text accompanying notes 180–82.

100. *Speculative Investment in Energy Markets: Hearing Before the S. Comm. on Energy and Natural Res.*, 110th Cong. 29 (2008) [hereinafter *Speculative Investment*] (statement of Robert F. McCullough, Jr., Managing Partner, McCullough Research).

101. *Id.*

102. *Id.*

103. *Energy Speculation*, *supra* note 92, at 11 (statement of Michael Greenberger, Professor of Law, and Director, Center for Health and Homeland Security, University of Maryland).

104. *Role Responsibilities*, *supra* note 99, at 96, 98 (statement of James C. May, President and Chief Executive Officer, Air Transport Association).

105. *Energy Speculation*, *supra* note 92, at 3 (statement of Rep. Bart Stupack); *see id.* at 188 (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission).

market.[106] The NYMEX eventually took initiative and ordered Amaranth to "reduce its open positions" in the 7 billion dollar hedge fund.[107] However, Amaranth did not do so and actually increased its position on the ICE market.[108] Supposedly, "Amaranth caused a four dollar increase in the natural gas" prices.[109] But other evidence existed which concluded that Amaranth was merely responding to price fluctuation and supply and demand.[110] The price of natural gas decreased drastically by September 2006, and Amaranth went out of business.[111] An investigation was completed by the CFTC and the Federal Energy Regulation Commission (FERC), resulting in FERC

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106. *Id.* at 3 (statement of Rep. Bart Stupack). It is important to note the difference between BP and Amaranth. BP was buying futures in a commodity that they do business in, while Amaranth was an American Investment Advisor which managed hedge funds. *Id.*

107. *Id.* at 55 (statement of Thomas F. Lasala, Chief Regulatory Officer, Division of Compliance and Risk Management, New York Mercantile Exchange).

108. *Id.*

109. *Id.* at 114 (statement of Michael Greenberger, Professor of Law, and Director, Center for Health and Homeland Security, University of Maryland). "I would say to any member of this subcommittee that if you read nothing else, read the two bipartisan staff reports of the Senate Permanent Investigating Committee on speculation and crude oil prices and natural gas. They are dated June 27, 2006, and June 25, 2007. The first report says '$20 to $30 added to crude oil price.' The second report says 'Amaranth caused a $4 increase in natural gas.' Both reports say, this has got to stop. The first report says, the loophole has to be closed, and an Atlanta company with United States trading engines and using United States-delivered contracts should not be delivered by the United Kingdom." *Id.*

110. *Id.* at 126 (statement of Rep. Michael C. Burgess) ("For instance, although a number of facts presented in the report support the conclusion that Amaranth's trading activity was the primary cause of the large differences between winter and summer futures prices that prevailed throughout 2006, other facts seem to indicate the opposite, that the market fundamentals and price changes influenced Amaranth's positions. These facts suggest that, at least at times, Amaranth was responding to the market rather than driving it. For example, although the price of natural gas declined substantially after Amaranth's demise, this alone does not prove that Amaranth's ability to elevate prices above supply-and-demand fundamentals, rather that the market may have simply reevaluated those fundamentals in light of the hurricane season ending without a major event and the prediction of a warm winter. It is clear that different conclusions can be drawn from the same set of facts.").

111. *See id.* at 36 (statement of Laura Campbell, Assistant Manager, Energy Resource, Memphis Light, Gas, and Water).

proposing a $291 million sanction.[112]

By 2008, Congress responded by closing the Enron loophole through the 2008 Farm Bill, thus regulating the so-called "dark markets."[113] Congress allowed the CFTC to regulate these markets enough to provide some transparency to detect manipulation of the commodity markets.[114]

2. Spiking Oil Prices

In 2008, oil prices soared.[115] The cause of the increased oil prices became a national concern.[116] Michael Masters[117] argued that speculators influenced the oil prices.[118] He stated, "The CFTC has granted Wall Street banks an exemption from speculative position limits when these banks hedge over-the-counter swaps transactions. This has effectively opened a loophole for unlimited speculation."[119] Masters blamed index

112. *Id*. at 3 (statement of Rep. Bart Stupack).

113. Food, Conservation, and Energy Act of 2008, Pub. L. No. 110–234, 122 Stat. 923 (2008) (to be codified at 7 U.S.C. § 8701). "Unregulated markets are known as dark markets, because there is very little oversight of the trades." *Energy Speculation*, *supra* note 92, at 2 (statement of Rep. Bart Stupack). As exemplified through the Enron and Amarath examples, energy markets, prior to 2008, were dark markets. *See id*. at 3. Thus, no one regulated any part of the contracts being exchanged, nor the people or entities exchanging them. *See id*. at 2–3.

114. 122 Stat. 923.

115. *Oil hits new high on Iran fears*, BBC NEWS, http://news.bbc.co.uk/2/hi/7501939.stm (last updated July 11, 2008). On July 11, 2008 oil reached an all time high of $147.27 per barrel before it began a steady decline. *Id*.

116. *See Data Drilling*, ECONOMIST (Sept. 10, 2009), *available at* http://www.economist.com/node/14415775.

117. Michael Masters "is both a hedge fund founder and manager and has researched the effect of speculators—particularly those operating in over-the-counter markets outside the scope of the CFTC's jurisdiction—on commodity markets." *High Price of Commodities—2008: Hearings Before the S. Comm. on Homeland Sec. & Govt'l Affairs*, 110th Cong. 40 (2008) [hereinafter *High Price*] (statement of Jeffrey H. Harris, Chief Economist, U.S. Commodity Futures Trading Commission).

118. *See id*. (statement of Michael Masters, Managing Member and Portfolio Manager, Masters Capital Management) ("You have asked a question: Are institutional investors contributing to food and energy price inflation? And my unequivocal answer is yes.").

119. *Id*. at 42.

speculators who trade in commodity index swaps[120] because swaps do not have speculative limits. He further explained:

> [T]he really shocking thing about the swaps loophole is that speculators of all stripes can use it to access the futures markets. So if a hedge fund wants a $500 million position in wheat, which is way beyond position limits, they can just enter into swap with a Wall Street bank, and then the bank buys as a surrogate $500 million worth of wheat futures.[121]

Masters urged the Senate to close the swaps loophole immediately.[122] He believed "[s]peculative position limits must 'look through' the swaps transaction to the ultimate counterparty and hold that counterparty to the speculative position limits. This would curtail index speculation, and it would force all speculators to face position limits."[123]

Unlike Masters, others did not blame the speculators for the manipulation of the price of oil. For example, Jeffrey Harris, the Chief Economist for the CFTC, argued there was hardly any "economic evidence" that confirmed the price of oil was being driven by speculators in this market.[124] Harris noted other commodity prices had risen that had not "developed futures markets" nor institutional investments, and he highlighted other "[m]arkets where index trading [was] the greatest as a

120. *Id*. "Typically, index funds are institutional investors who engage in passive investments. Passive investors typically buy a long position and hold it to a predetermined time. On the other hand, hedge funds tend to be more responsive to market signals, trading in a manner that is similar to the traditional speculative participant that we have seen historically. As such, hedge funds are more appropriately subject to speculative position limits of the markets and of the Commission." *Id*. at 44 (statement of Thomas J. Erickson, Chairman, Commodity Markets Council).

121. *Id*. at 42 (statement of Michael Masters, Managing Member and Portfolio Manager, Masters Capital Management).

122. *Id*. at 43.

123. *Id*. Masters also recommended that Congress "reclassify all the positions in the Commercial category of the Commitments of Traders Reports to distinguish those positions that are controlled by 'Bona Fide' Physical Hedgers from those controlled by Wall Street Banks. The positions of Wall Street banks should be further broken down based on their OTC swaps counter-party into 'Bona Fide' Physical Hedgers and Speculators." *Id*. at 197.

124. *Id*. at 39 (statement of Jeffrey H. Harris, Chief Economist, Commodities Future Trading Commission).

percentage of total open interest" prices had fallen over the past year.[125] Harris explained the amount of speculation within the agricultural commodities and the oil markets "remained relatively constant" even though prices continued to increase.[126] Studies showed speculators follow trends and do not set them, and importantly, speculators "are both buyers and sellers in [the] markets."[127] Similarly, Lawrence Eagles[128] argued "investment has not in fact caused commodity price inflation."[129] He stated, "[there is] a very strong correlation between the consumption of Tylenol and the frequency of headaches, but that [does not] imply causality."[130] He based his position on the laws of supply and demand and referenced in part to the high demand of oil in China, India, and the Middle East.[131]

125. *Id.*

126. *Id.*

127. *Id.* "All the data modeling and analysis we have done to date indicates there is little economic evidence to demonstrate that prices are being systematically driven by speculators in these markets. Generally, the data shows that: Prices have risen sharply for many commodities that have neither developed futures markets (e.g., durham wheat, steel, iron ore, coal, etc.) nor institutional fund investments (Minneapolis wheat and Chicago rice). Markets where index trading is greatest as a percentage of total open interest (live cattle and hog futures) have actually suffered from falling prices during the past year. The level of speculation in the agriculture commodity and the crude oil markets has remained relatively constant in percentage terms as prices have risen. Our studies in agriculture and crude oil markets have found that speculators tend to follow trends in prices rather than set them. Speculators such as managed money traders are both buyers and sellers in these markets. For example, data shows that there are almost as many bearish funds as bullish funds in wheat and crude oil." *Id.* at 189 (written testimony of Jeffrey H. Harris, Chief Economist, Commodities Future Trading Commission).

128. Lawrence Eagles, at the time, was JP Morgan Chase's Global Head of Commodity Research. *Speculative Investment*, *supra* note 100, at 35.

129. *Id.* at 36 (statement of Lawrence Eagles, Global Head of Commodity Research, JP Morgan Chase).

130. *Id.*

131. *Id.*

3. New Administration

In January 2009, President Barack Obama entered office with a pro-regulation administration.[132] Specifically, in September 2009, President Obama made a speech stating:

> [W]e're proposing the most ambitious overhaul of the financial regulatory system since the Great Depression. But I want to emphasize that these reforms are rooted in a simple principle: We ought to set clear rules of the road that promote transparency and accountability. That's how we'll make certain that markets foster responsibility, not recklessness. That's how we'll make certain that markets reward those who compete honestly and vigorously within the system, instead of those who are trying to game the system.[133]

President Obama clearly supported the new legislation being promoted in Congress.[134] In this speech, he specifically referenced closing financial loopholes through regulation.[135]

132. *See Gary Gensler, Derivatives Cop: A New Sheriff*, ECONOMIST, Sept. 3, 2009, http://www.economist.com/node/14365076 [hereinafter *Derivatives Cop*].

133. Remarks by the President on Financial Rescue and Reform, 2009 DAILY COMP. PRES. DOC. 706 (Sept. 14, 2009) [hereinafter *Address on Financial Reform*], *available at* http://www.gpo.gov/fdsys/pkg/DCPD-200900706/pdf/DCPD-200900706.pdf.

134. *Id*. The Consumer Financial Protection Agency Act of 2009 was mentioned in his speech and later that year, specifically, December 11, 2009 the H.R. 4173 bill passed and ultimately the Dodd-Frank Act that dictates much of President Obama's concerns in the speech was passed on July 21, 2010. Dodd-Frank Wall Street Reform and Consumer Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

135. *Address on Financial Reform*, *supra* note 133. "[W]e've got to close the loopholes that were at the heart of the crisis. Where there were gaps in the rules, regulators lacked the authority to take action. Where there were overlaps, regulators often lacked accountability for inaction. These weaknesses in oversight engendered systematic, and systemic, abuse. Under existing rules, some companies can actually shop for the regulator of their choice—and others, like hedge funds, can operate outside of the regulatory system altogether. We've seen the development of financial instruments—like derivatives and credit default swaps—without anyone examining the risks, or regulating all of the players. And we've seen lenders profit by providing loans to borrowers who they knew would never repay, because the lender offloaded the loan and the consequences to somebody else. Those who refuse to game the system are at a disadvantage. Now, one of the main reasons this crisis could take place is that many agencies and regulators were responsible for oversight of individual financial firms and their subsidiaries, but no one was responsible for protecting

Gary Gensler,[136] the new head of the CFTC under the Obama Administration, was thought to be a friend of the financial industry, but he too has emphasized regulation of financial markets.[137] One of Gensler's beliefs and focuses was new regulation due to the high oil prices of 2008.[138] Gensler thought that an asset bubble[139] caused the commodities' prices to rise; however, he argued position limits should be regulated so that a small group does not control and influence the future influxes of pricing.[140] With President Obama and his administration including Gensler, new regulatory standards for the speculators

[the whole system]. . . . In other words, regulators were charged with seeing the trees, but not the forest. And even then, some firms that posed a "systemic risk" were not regulated as strongly as others, exploiting loopholes in the system to take on greater risk with less scrutiny. As a result, the failure of one firm threatened the viability of many others. We were facing one of the largest financial crises in history, and those responsible for oversight were caught off guard and without the authority to act." *Id*.

136. Gary Gensler was "a partner at Goldman Sachs and later served under Bill Clinton's famously deregulatory Treasury secretary, Larry Summers." *Derivatives Cop*, *supra* note 132. However, when he was named head of the CFTC it gave muscle to the organization, which had struggled for power against the Security Exchange Commission (SEC) for years. *Id*. Since the CFTC was created there has been increasing competition between the CFTC and the SEC. Hazen, *supra* note 68, at 388–89. The CFTCA gave the power to regulate futures and commodity options to the CFTC and not the SEC, which also regulates options over securities. *Id*. Thus, the SEC has become competitive with the increased trading in derivatives. *Id*.

137. *See Derivatives Cop*, *supra* note 132.

138. *Id*.

139. An asset bubble is an unexplainable asset price movement because the variables on which individuals normally rely to determine prices do not explain the movement. PETER M. GARBER, FAMOUS FIRST BUBBLES: THE FUNDAMENTALS OF EARLY MANIAS, 4–5 (2000). Speculators are not manipulating the market, but are involved in an economic phenomenon. *See id*. When the market rises more speculators decide to buy the commodity and the market continues to increase. *See id*. It is not until an asset bubble bursts that the world realizes that the commodity was not tied to the underlying value. *Id*. at 7–8. Asset bubbles have occurred throughout history, and the most famous are the "Dutch tulip mania (1634–1637), the Mississippi Bubble (1719–1720) and the closely connected South Sea Bubble (1720)." *Id*. at 12.

140. *Derivatives Cop*, *supra* note 132. ("Although [Gensler] thinks commodities experienced an asset bubble, he says his real interest in position limits is to prevent a growing concentration of trading among a few players that could permit speculative swings in prices in the future.").

in the commodity markets were a certainty.[141]

IV. CREATION OF NEW LEGISLATION

On July 21, 2010, President Obama signed the Dodd-Frank Act.[142] The Dodd-Frank Act was promoted "to provide for financial regulatory reform, to protect consumers and investors, to enhance Federal understanding of insurance issues, to regulate the over-the-counter derivatives markets, and for other purposes."[143]

The Dodd-Frank Act attempts to combat manipulation by regulating, for the first time, the swaps market under Title VII.[144] Specifically, the CFTC will now regulate "$615 trillion over-the-counter derivatives market."[145] However, with this massive regulation, which alters the existing market drastically, scholars worry about the impact this legislation may have on the market.[146]

V. TRANSPARENCY

The main goal of the Dodd-Frank Act is to make the swaps market transparent in order to combat manipulation that could occur on a "dark" swaps market.[147] The swaps market achieves transparency through the following four mechanisms: (1) clearing the swaps; (2) trading on a board; (3) reporting the outcomes; and

141. *See id.*

142. On December 11, 2009 the House of Representatives passed H.R. 4173: Wall Street Reform Consumer Protection Act of 2009. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010). This bill was introduced in the House on December 2, 2009 and passed by the House and Senate on December 11, 2009, and May 20, 2010, respectively. *Id.* This bill contained many titles addressing numerous financial issues. *See id.*

143. *Id.*

144. *See* Dodd-Frank Act § 716.

145. Sarah N. Lynch, *CFTC May Finish Proposed Swap Rules by Mid-December*, WALL ST. J. (Oct. 21, 2010, 1:27 PM), http://online.wsj.com/article/SB10001424052702304023804575566313234331490.html [hereinafter Lynch].

146. *See id.*

147. Anna Raff, *CFTC Details Oversight on Swaps*, WALL ST. J., Sept. 17, 2010, at C3, *available at* http://online.wsj.com/article/SB10001424052748704394704575495723231513104.html.

(4) regulating conduct.[148]

A. Clearing

To achieve transparency, swaps contracts are required to trade through a third party known as a clearinghouse similar to futures contracts.[149] Because swaps will be traded through a clearinghouse, this ensures the swap will be guaranteed if a party defaults.[150] A party to a swap transaction must submit the swap to a clearing organization to be "cleared," and the clearing organization must submit to the CFTC any swaps it intends to accept for clearing.[151] The CFTC reviews the submitted swaps as to whether they should be cleared and provides a "30-day public comment period" following their decision.[152] In the CFTC's review of the swap, it evaluates the swap on several factors, including "trading liquidity, and adequate pricing data"; "the availability of 'resources and credit support to clear the contract'"; "effect on the mitigation of systemic risk"; "the effect

148. Section 716 of the Dodd-Frank Act describes the Swaps Push-Out Rule. Dodd-Frank Act § 716. The goal of this section is to limit the big banks from being speculators in the swaps market. *See generally id*. The Swaps Push-Out Rule limits federal funding to banks that engage in swap transactions for purposes other than bona fide hedging and mitigating risks, or other traditional banking activities. *Id*. Specifically, "U.S. commercial banks' commodity contracts were valued at as much as $979 billion at the end of 2009 by the Treasury Department, up from $289 billion five years earlier." Jerry A. Dicolo, *Speculative Activity in Commodities Is Likely to Continue*, WALL ST. J., Sept. 7, 2010,http://online.wsj.com/article/SB10001424052748704855104575470081333114358.html. Today most of the commodity contracts have resulted from swap deals. *Id*. Nobody knows with "'any degree of accuracy what the long-term effect [of this provision] is likely to be . . . [b]ut one of the immediate consequences is a lot less liquidity for a whole range of products.'" *Id*. (quoting Paul Forrester, a partner at law firm Mayer Brown which specializes in energy markets). Although the Swaps Push-Out Rule will drastically affect the swaps market, it is beyond the scope of this Note.

149. Dodd-Frank Act § 723(a)(3). For more information on clearinghouses, see *supra* text accompanying notes 35–39. "If one of the counterparties to the swap[:] (i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the [CFTC], . . . [as to] how it generally meets its financial obligations associated with entering into non-cleared swaps," then it will be exempted from the clearing requirement. Dodd-Frank Act § 723(a)(3).

150. Raff, *supra* note 147.

151. Dodd-Frank Act § 723(a)(3) (regulates clearing organizations).

152. *Id*.

on competition"; "the existence of reasonable legal certainty in the event of the insolvency" as to the clearing organization and "swap counterparty positions."[153] After this review, if the swap is characterized as eligible for clearing, then it is subject to additional regulations.[154] Additional rules will be created by the CFTC before the clearing requirement takes effect.[155]

Through this obligation to clear swap transactions, the swaps market will be more transparent.[156] Now, the CFTC will know which swaps are being traded and can impose further regulations on the swaps that are not eligible to be cleared.[157]

B. Trading

A swap execution facility will operate similar to a board of trade.[158] Swaps that must be cleared must also trade through a swap execution facility.[159] By obligating that swaps be traded through a swaps execution facility, the swaps market will become more transparent like the futures markets.[160]

C. Reporting

As another means to make the swaps market transparent, certain swaps are obligated to submit to real time public reporting requirements.[161] The purpose of the reporting

153. *Id*.

154. Sarah N. Lynch, *CFTC Says New Rules Will Get Vote Next Week*, WALL ST. J., Sept. 22, 2010, at C3, *available at* http://online.wsj.com/article/SB10001424052748704129204575505663890651110.html?KEYWORDS=Lynch [hereinafter *CFTC Says New Rules*]; *see also infra* text accompanying notes 166–67 (explaining margin requirements for non-cleared swaps).

155. *CFTC Says New Rules*, *supra* note 151.

156. *See generally High Price*, *supra* note 117 (statement of Michael Masters, Managing Member and Portfolio Manager, Masters Capital Management). *See supra* text accompanying notes 35–39.

157. *See* Dodd-Frank Act § 723; *see infra* text accompanying notes 164–65.

158. *See* Dodd-Frank Act § 733.

159. *Id*; *see supra* text accompanying notes 31–34.

160. *See generally High Price*, *supra* note 117 (statement of Michael Masters, Managing Member and Portfolio Manager, Masters Capital Management).

161. Dodd-Frank Act § 727. "'[R]eal-time public reporting' means to report data relating to a swap transaction, including price and volume, as soon as

requirement is to authorize the CFTC "to make swap transaction and pricing data available to the public in such form and at such times as the Commission determines appropriate to enhance price discovery."[162] To achieve this, each swap subject to this requirement must be reported to a registered swap data repository.[163] Most entities obligated under this requirement will be defined as major swap participants and swap dealers,[164] and they must keep books and daily trading records of the transactions they trade.[165] The CFTC must issue a report every six months to the public regarding "those swaps that are subject to the mandatory clearing requirement."[166] This reporting requirement will make the swaps market more transparent because the records of the swaps transactions will be available at all times for the CFTC to review.

D. Regulating Conduct

To achieve a transparent swaps market, the CFTC will regulate conduct through controlling the risk by setting margins and position limits, obligating the parties to abide by business conduct standards, and approving new rules and products.

1. Margin and Position Limits

The CFTC will regulate the conduct of the parties to a swap transaction by setting margin and position limits.[167] When the transaction is categorized as a non-cleared swap transaction, the parties will be obligated to abide by capital and margin limits set by the CFTC.[168] Additionally, the CFTC's margin requirements

technologically practicable after the time at which the swap transaction has been executed." *Id.*

162. *Id.*

163. *Id.*

164. The Dodd-Frank Act specifically defines major swap participants and swap dealers in § 721. *Id.* § 721. Further rules determining which entities are regulated as major swap participants and swap dealers will be decided by the CFTC. *Id.*

165. *Id.* § 731 "4s".

166. *Id.* § 727.

167. *Id.* § 731.

168. *Id.*

may be non-cash collateral as long as it "preserv[es] the financial integrity of markets trading swaps; and preserv[es] the stability of the United States financial system."[169]

Prior to the Dodd-Frank Act, the CEA gave the authority to the CFTC to set position limits.[170] However, the CFTC delegated to the exchanges the authority to set position limits in the commodities. Specifically, the CFTC only enforced "speculative position limits . . . on a limited group of agricultural commodities."[171] All the other exchanges established their own speculative limits.

Now, the Dodd-Frank Act creates an "absolute obligation on the CFTC to impose hard limits."[172] The CFTC must "establish limits on the amount of positions . . . other than bona fide hedge positions"[173] that are held by persons involved in future delivery sale contracts or "options on the contracts or commodities traded on or subject to the rules of a designated contract market."[174] Additionally, the CFTC must limit the aggregate number of contracts a person—including a group or class of traders—may

169. *Id.*

170. *See* Commodity Exchange Act, 7 U.S.C. § 2 (2006).

171. *Over the Counter Derivatives Reform and Addressing Systemic Risk*: *Hearing Before the S. Comm. on Agric., Nutrition & Forestry*, 111th Cong. 78 (2009) [hereinafter *Derivatives*] (statement of Terrence A. Duffy, Executive Chairman CME Group).

172. *Id.*

173. Dodd-Frank Act § 737(a)(4). The Dodd-Frank Act defines a "bona fide hedging transaction" as a position that represents a position taken or will be taken in the future in a physical marketing channel that is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and arises from the potential change in the value of assets, liabilities, services. *Id.* § 737(c). Or it is a position that "reduces risks attendant to a position resulting from a swap that was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction." *Id.* For example, "[e]nterprises that consume a commodity that is not used in a 'physical marketing channel' such as airlines that use fuel, generating facilities that use gas and produce electricity . . . will not be entitled to a hedge exemption from mandatory speculative limits. Moreover any limitation on hedge exemptions for swap dealers [would] limit the ability of commercial enterprises to execute strategies in the OTC market to meet their hedging needs." *Derivatives*, *supra* note 171, at 80 (statement of Terrence A. Duffy, Executive Chairman CME Group).

174. Dodd-Frank Act § 737(a)(4).

hold on the same commodity for each month.[175] As the CFTC determines the position limits that must be implemented, it should "not cause price discovery in the commodity to shift to trading on the foreign boards of trade."[176] The CFTC must weigh factors, such as price linkage,[177] arbitrage,[178] material price reference,[179] and material liquidity,[180] in order to determine if a swap "serves a significant price discovery function . . . ."[181] However, not all swaps are subject to this requirement because the CFTC has the liberal power of exempting any swap from any of the position limit requirements.[182]

2. Business Conduct Standards

Additionally, the CFTC regulates conduct by requiring the parties of a swap transaction to comply with the business conduct standards it creates.[183] These standards are intended to regulate fraud, manipulation, and abusive conduct.[184] Specifically, for example, these standards will regulate the parties' ability to

175. *Id.*

176. *Id.*

177. Price linkage is defined as, "[t]he extent to which the swap uses or otherwise relies on a daily or final settlement price, or other major price parameter, of another contract traded on a regulated market based upon the same underlying commodity, to value a position, transfer or convert a position, financially settle a position, or close out a position." *Id.*

178. Arbitrage means, "[t]he extent to which the price for the swap is sufficiently related to the price of another contract traded on a regulated market based upon the same underlying commodity so as to permit market participants to effectively arbitrage between the markets by simultaneously maintaining positions or executing trades in the swaps on a frequent and recurring basis." *Id.*

179. Material price reference is defined as, "[t]he extent to which, on a frequent and recurring basis, bids, offers, or transactions in a contract traded on a regulated market are directly based on, or are determined by referencing, the price generated by the swap." *Id.*

180. Material liquidity is "[t]he extent to which the volume of swaps being traded in the commodity is sufficient to have a material effect on another contract traded on a regulated market." *Id.*

181. *Id.* This is not a limited list of factors. *Id.*

182. *Id.*

183. *Id.* § 731.

184. *Id.*

abide by the position limits set by the CFTC.[185] Additionally, these business conduct rules must: (1) create a duty for swap dealers or major swap participants to "verify" that counterparties are eligible to be a participate; (2) disclose risks, conflicts of interest, and receipt the daily marks of the transaction to any non-swap dealer counterparty; and (3) create a duty to communicate, implicating the doctrine of good faith and fair dealing between parties.[186]

3. New Rules and Product Approval

Moreover, the CFTC will regulate conduct through a new product approval regime. Prior to the Dodd-Frank Act, the CFTC regulated conduct through a principle-based regime. Principle-based regulation required entities to meet certain core principles; however, these entities could follow certain actions approved by the CFTC, or they could adhere to their own practices.[187] This provided much freedom and flexibility.[188]

Now, the principle-based regulation has been eliminated, and a new product approval regime has been implemented.[189] Under the proposed rules, the entities must submit documents that relay the entity's compliance with the Dodd-Frank Act along with their product submission.[190] Additionally, the CFTC has the authority to judge new contracts and rules.[191] A new rule or contract will not become effective for ten days,[192] and the CFTC may delay the new rule or contract ninety days for further review

185. *Id.*

186. *Id.*

187. Walter Lukken, Comm'r, Commodity Futures Trading Comm'n, address at University of Houston's Global Energy Management Institute: It's a Matter of Principles (Jan. 25, 2007), *available at* http://www.cftc.gov/PressRoom/Speeches Testimony/opalukken-23.html.

188. *Id.*

189. *See* Dodd-Frank Act § 717.

190. U.S. Commodity Futures Trading Comm'n, *Q & A On CFTC Proposed Rule on Part 40 of Commish Regs -1*, IMARKETNEWS.COM (Oct. 26, 2010, 9:41 AM), http://imarketnews.com/node/21385.

191. *See* Dodd-Frank Act § 745(b); *Derivatives*, *supra* note 171, at 77 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

192. Dodd-Frank Act § 745(b).

if necessary.[193] Regulating conduct will help the swaps market become more transparent.[194] With the CFTC controlling the risk through setting margin and position limits, the CFTC and the public will be assured that the parties are not guaranteeing over a designated amount.[195] The CFTC will have the resources to enforce and protect against manipulation with the business conduct rules, and the CFTC will have oversight on all new rules and product approval.[196] Regulating conduct, reporting, trading and clearing will make the swaps market transparent, which will essentially monitor all parties involved so there is much less risk of speculators manipulating the market.[197]

VI. PROBLEMS

Although the Dodd-Frank Act does create transparency in the swaps market, this regulatory scheme causes unintended consequences such as less liquidity in the market, administrative inefficiency, and cost. While administrative inefficiency and cost may be fixed, less liquidity in the market place may not be.

A. Less Liquidity

A major consequence to regulating the swaps markets is the risk that the market will become less liquid. Chairman Lukken explains the importance of speculation and the impact less liquidity has on a market. He states:

> Speculators provide the market liquidity to allow hedgers to manage various commercial risks. Placing limitations on the amount of speculation in a futures market, whether by an individual trader or all traders, necessarily limits the amount of liquidity in the marketplace. Such limitations may restrict the ability of hedgers to manage risks, and may limit

193. *Id.*; *see also Derivatives*, *supra* note 171, at 77 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

194. *See High Price*, *supra* note 117, at 40–43 (statement of Michael Masters, Managing Member and Portfolio Manager, Masters Capital Management).

195. *See id.*

196. *See id.*

197. *See id.*

> information flow into the marketplace, which could in turn negatively affect the price discovery process and the hedging function of the marketplace. As agricultural and energy producers are often short hedgers and as commercials generally tend to be short, a limitation on speculation tends to be a restriction on buyers. Ultimately, if long speculation is artificially driven from the market, the potential short-term advantage of lower prices could lead to production shortages, higher demand, and even higher prices for both energy and agricultural commodities.[198]

When a market that was essentially unregulated now is burdened with restrictions such as clearing, trading, reporting, and new regulating conduct, there is a risk the market will become less liquid.[199] This risk could become a reality because speculators could choose to leave the U.S. board of trade and trade their commodities on a foreign board of trade, inevitably making the U.S. market less liquid.[200] The regulations that set margins were described as "a very blunt tool" because that limitation could potentially cause markets to move overseas or underground, in essence causing there to be less liquidity in the market.[201] Additionally, this issue is even more important to consider because now the CFTC may regulate the energy commodities.[202] For instance:

198. *See Role Responsibilities, supra* note 99, at 95 (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission).

199. *Derivatives*, *supra* note 171, at 74 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

200. *See id.* ("[T]he threat of such policies has already driven major customers to move business off U.S. markets.").

201. *Role Responsibilities*, *supra* note 99, at 24 (statement of Walter Lukken, Acting Chairman, U.S. Commodity Futures Trading Commission). "I think if you raise margin—I would assume that people want to try to drive speculators and drive prices down. I am not sure that would be the ultimate effect. Certainly, it would probably drive these markets elsewhere where there are competitive choices—overseas or OTC. So that is a concern. I think there are more direct ways to try to get at this activity through transparency and spec limits that we currently have in place." *Id.* at 24.

202. In the Dodd-Frank Act, energy swaps are included as part of swaps transactions that the CFTC may regulate. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 721(a), 124 Stat. § 1658 (2010) (to be codified at 7 U.S.C. § 1a).

> [A]lthough Natural Gas delivered at Henry Hub is a natural U.S. product and it is not likely that that specific contract will move offshore, natural gas is [actually] a global product and it is certain that a new global benchmark contract will emerge on a foreign exchange if trading on U.S. markets is constricted by inappropriate limits. The likely chain of effects is predictable and unacceptable; liquidity of U.S. markets will be impaired, causing damage to the domestic natural gas industry and its customers.[203]

Any harsh regulation will force speculators overseas or underground and this in effect would cause there to be less liquidity in the market.

B. Administrative Inefficiency

Administrative inefficiency is another consequence of the swaps market becoming transparent. Specifically, the dual regulatory regime, the new rules and product approval, and the risk of political influences when the CFTC sets the position limits causes this inefficiency.

1. Dual Regulatory Regime

The SEC and the CFTC both have jurisdiction over regulating the swaps markets.[204] The SEC will regulate security based swaps and the CFTC will regulate commodity based swaps. However, mixed swaps will be jointly regulated by both commissions.[205] Some participants may have to register with both entities and be subject to regulatory requirements of both entities.[206] Both the SEC and the CFTC are required to consult with each other when creating the rules that each entity is obligated to write.[207] For a long time the SEC and the CFTC have battled over authority to control the markets. Because a

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203. *Derivatives*, *supra* note 171, at 80 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

204. *See* Dodd-Frank Act § 712(a)(1)–(2).

205. *Id.* § 712(a)(8).

206. *Id.* § 731; *see Derivatives*, *supra* note 171, at 82–83 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

207. Dodd-Frank Act § 712(a)(1)–(2).

primary regulatory entity does not control this market, there will be less harmonization and greater inefficiency, and this will pose difficulty to all involved.[208]

2. Rules and Product Approval

The product approval system of regulation may instigate new problems in the U.S. markets, specifically, how others view the U.S. markets around the globe. This "[will] put participants in the U.S. futures markets at a significant competitive disadvantage when compared to their foreign competitors."[209] The prior regulatory structure based on core principles allowed the U.S. futures exchanges to change rapidly with new innovative technology.[210] Additionally, it allowed others to adapt quickly to the market needs "by introducing new products, new processes and new methods by certifying compliance with the CEA and thereby avoiding stifling regulatory review. U.S. futures exchanges operate more efficiently, more economically and with fewer complaints under [that] system than at any time in their history."[211] The principle-based regulation adopted by the CFMA has been crucial in the U.S.'s ability to be competitive in the global market, and now with the new product approval regime, this efficiency will no longer exist.[212]

3. Political Influences

The CFTC has the power to set "position limits," and there is a risk that this new power will be influenced by politics.[213] "It is critical that position limits [do] not become a political tool [when they attempt] to control the underlying prices in the cash market."[214] "[A]ny attempt to use position limits for this purpose

208. *Derivatives*, *supra* note 171, at 83 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

209. *Id*. at 77.

210. *Id*. at 75.

211. *Id*.

212. *Id*. at 32; *see supra* note 89 and accompanying text.

213. *See Derivatives*, *supra* note 171, at 79 (statement of Terrence A. Duffy, Executive Chairman, CME Group).

214. *Id*.

will have a devastating impact on the U.S. futures industry and participants that rely on these markets to manage risk."[215] Basically the risk is "allowing self-interested entities a more formal role in the setting of position limits[, which] creates incentive for them to argue what is in their own individual self-interest and politicizes a process that should not be politicized."[216]

C. Cost

Additional costs will be a major consequence to making the swaps market transparent, including both costs to the government or the taxpayers to regulate this market and costs to the speculators participating in this market. Implementing these new procedures that ensure transparency will be a vast expense, which must be budgeted for in the future by the speculators being regulated as well as the government conducting these procedures.[217] "The Natural Gas Supply Association and the National Corn Growers Association estimated that the costs of mandating clearing and margining for the whole OTC derivatives market could hit $900 billion."[218]

Additionally, these margin limits will impose a new cost on parties to the transaction that normally trade in this market. "In April, a Business Roundtable survey estimated that, without an exemption, non-financial end-users in the S&P 500 would need to set aside an average of $269 million each in initial margin to comply with the new law, or $33.1 billion combined."[219] If such a large sum is set aside for new margin limits, then this would directly impact and lower the amount of liquidity in the market place.

215. *Id*.
216. *Id*.
217. *See* Katy Burne, *Minimum Thresholds for Swaps Urged*, WALL ST. J. (Sept. 29, 2010, 10:11 PM), http://online.wsj.com/article/SB10001424052748704116004575522782759846268.html?KEYWORDS=minimum+threshold+for+swaps+urged.
218. *Id*.
219. *Id*.

VII. THE FUTURE

The Dodd-Frank Act is not immediately implemented in its entirety, but instead there are numerous effective dates[220] for different sections and many rules[221] that must be created. By the time all of the titles are fully implemented, political change likely will have occurred.[222]

Since the passing of the Dodd-Frank Act in July 2010, there has already been a shift in the majority in Congress.[223] At the time the Dodd-Frank Act was passed, the Democrats held the majority. However, on November 2, 2010, the election results revealed that in 2011, the Republicans would have control.[224] The Republicans now hold the majority of seats in the House of Representatives with 239 seats leaving the Democrats holding

220. Although the Act officially became a law on July 21, 2010, many of the provisions will not become effective until days, months or years later. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010). The effective date of many of the subtitles of this part of the Act is the later of either July 21, 2011 or sixty days after publication of the final rule for a section that requires a ruling. *Id.* § 754. The Swaps Push-Out Rule, for example, will not take effect until July 21, 2012, at the earliest. *Id.* § 716(h). Another title of the act which may impact the swaps market participants is the Volcker Rule, which was created to prevent manipulation. *See id.* § 619. The Volcker Rule may not become effective for twelve years. *See id.*; *see also* David Weidner, *Why Wall Street May Love a Punishing Election*, WALL ST. J. (Oct. 13 2010, 3:44 PM), http://online.wsj.com/article/SB10001424052748703673604575550352948151266.html?KEYWORDS=election.

221. The CFTC has chosen to write rules in thirty areas that regulate the swaps market. *Rulemaking Areas*, U.S. Commodity Futures Trading Commission, http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/index.htm (last visited Apr. 9, 2011). These rules are determined through "roundtable" discussions, which are open to the public. Damian Paletta & Victoria McGrane, *Fighting Flares on New Rules For Street*, WALL ST. J., Aug. 21, 2010, at B1, *available at* http://online.wsj.com/article/SB10001424052748703579804575441750105850046.html. After the committee proposes a rule, then it is open for public comment. Dodd-Frank Act § 745(b). After a period of public comment, then the committee must vote a second time on the proposed rule for it to be adopted. *Id.*

222. *See* Rhodes Cook, *Politics Untethered*, CAPITAL J. (Nov. 4, 2010, 2:41 PM), http://blogs.wsj.com/capitaljournal/2010/11/04/politics-untethered.

223. *See 2010 Elections: Full Results by State*, WALL ST. J., http://newsapps.wsj.com/elections2010/#race=house (last visited Apr. 9, 2011).

224. *See id.*

189 seats.[225] Currently, the Democrats have a total of fifty-three seats in the Senate,[226] and the Republicans hold forty-six seats.[227]

Over the years, politics will only continue to shape the Dodd-Frank Act.[228] For example, due to the high costs in regulating the swap markets, the budget for these regulations will need to be approved by Congress, and every year there will be a need for continuous support.[229] Thus, even though of the Dodd-Frank Act is now federal law, a majority of the Act still remains uncertain. All that is clear is that "'[r]eform is a long, winding road, and we've just started the journey.'"[230]

VIII. CONCLUSION

Understandably, in an economic downturn the public looks to the government for guidance, to act as its savior, to punish wrongdoers, and to prevent a reoccurence in the future. Initially, the public is shocked, angry, hurt and desperate from such economic depression and they want answers. However, in a situation such as the current economic depression, it is not in the public's best interest for the government to begin regulating previously unregulated markets. Liquidity in the market is the most crucial element to help the market recover. Implementing new rules and regulations on a market only deters those that are speculators from continuing to trade in that market, and they instead choose a different, perhaps a foreign, market to trade in. Again, by having less speculators, less transactions, less trades only reduces the liquidity in the market and inevitably hurts the economy.

Although, President Obama supported the Dodd-Frank Act in a time of economic turmoil, it is essential that the public

225. *Id.*

226. *Id.* Two of the fifty-three seats technically are independents, but they caucus with the Democrats. *Id.*

227. *Id.*

228. *See* Weidner, *supra* note 220.

229. *Id.*

230. *Id.* (statement of Margaret Tahyar, Partner, Davis Polk & Wardwell, who specializes in financial regulation.).

understand the economic impact of regulating a "dark" market, such as the swaps market. It is crucial to educate the public of the impact the Dodd-Frank Act will have on the economy because many of these regulations have not been implemented and may still be altered.