

## WHO'S MINDING CREDIT DEFAULT SWAPS?

Under the Commodity Futures Modernization Act (CFMA) passed by Congress in 2000, both the SEC and the CFTC were restricted from regulating the credit default swaps (CDS) market. The Act did provide the SEC with antifraud authority over CDSs; however, the “authority” was in fact an emasculated one: the SEC was specifically prohibited from imposing reporting, recordkeeping, or disclosure requirements or other measures designed to deter fraud in CDS agreements. The ability to actually monitor and prevent CDS fraud was a sham. The problem was deemed corrected in 2010 via specific CDS provisions in the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank.) Now four years later, some observers are questioning whether Dodd-Frank went far enough and is clear enough—or are CDSs poised to once again crash the financial party?

### Three-Headed Regulation

Under Dodd-Frank, CDS regulation is divided between the SEC and CFTC, with the SEC responsible for “security-based swaps”—which are based on a single security or loan or a group of securities—while the CFTC has regulatory authority over all other swaps including those based on energy and agriculture. The two agencies share authority over “mixed swaps,” which are security-based swaps that also have a commodity component. The authority to regulate capital and margin limits for swap entities that are banks is granted to the Federal Reserve. Furthermore, the SEC is charged with antifraud enforcement authority over swaps that are related to securities but that do not come within the definition of “security-based swap.”

### Joint Partners

Pursuant to Title VII of Dodd-Frank, the CFTC and SEC are required to jointly define key terms relating to jurisdiction, including *swap*, *security-based swap*, and *security-based swap agreement*, and party definitions such as *swap and security-based swap dealers* and *major swap and security-based swap participants*. They are also charged with adopting joint regulations regarding mixed swaps

and books and records requirements for swap entities related to security-based swap agreements. The SEC is required to consult with the CFTC and the Federal Reserve Board on non-joint rulemakings and with the other regulators on capital and margin rules.

### CDSs and Long-Term Prosperity

Despite the polychotomous regulation of CDSs, they continue to engender “exacerbated moral hazard issues” as noted by the Harvard Business Law Review last year, which also concluded: “People are better off fixing up their homes, and businesses are better off investing in new equipment, than going to Las Vegas and gambling. The same holds true in the financial realm... The issue of CDSs needs to be examined in light of how these instruments add or detract from our overall long-term prosperity.” [Murdock, Charles W., “Credit Default Swaps: Dubious Instruments,” 3 Harvard Bus. L. Rev. Online 133 (2013)]

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