

Contract or Regulation? The Risk of Blind Spots in OTC Derivatives Market Reforms

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The Issue

- A transnational private regulatory regime has been prevalent in OTC derivatives markets since the 1980's
- International Swaps and Derivatives Association (ISDA) has issued boilerplate contracts enforceable in particular courts (NY, London)
- SWAPS Code, Master Agreements 1987, 1992 and 2002
- Credit support annex, definitions etc
- Question is whether this regime can be conceptualised as a purely self contained private contract based regime?
- Could there be normative and practical regulatory 'blind spots', especially in light of recent reform proposals in the US and EU?

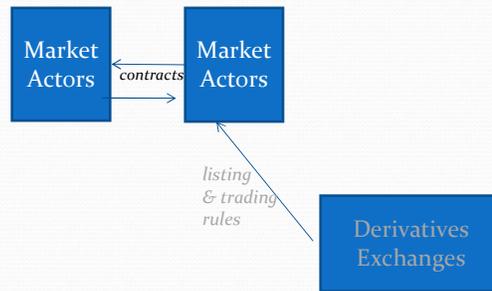
Derivatives – What are they?

- Have probably been used since at least 2000 B.C.
- Are 'bets' on stock, commodities, weather etc without necessarily physically owning the underlying
- Counterparties agree to pay or receive currency, dependant on whether or not some extrinsic, uncertain event occurs in future (Lynch 2011)
- Hedging theoretically beneficial in risk allocation
- Speculator with speculator trading more problematic. Zero sum or negative sum game. On average speculators will lose (Lewis 2010)
- May be considered analogous to traditional forms of gambling (Stout 1993-2011, Lynch 2011, Hazen 2005)
- Exchange traded and 'over the counter' (OTC)

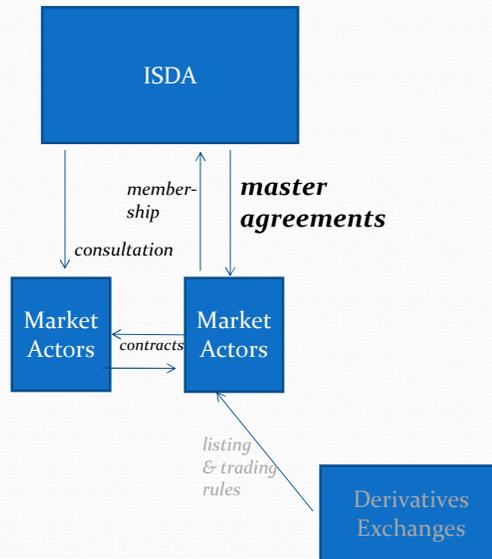
2000-2008 – What Happened?

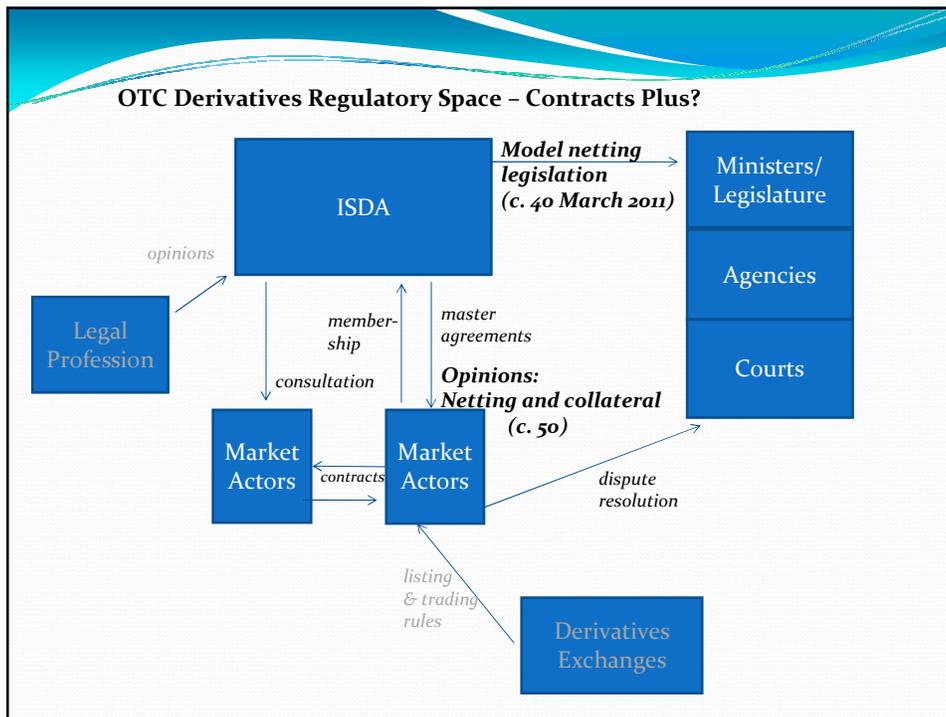
- After years of uncertainty lobbying (e.g. G30) and the 'Greenspan doctrine' heralded CFMA 2000, exempted OTC derivatives from regulation in the US while also rendered court enforceable. Old common law rule superseded
- UK FSMA 2000 mostly applicable general regulation (e.g. insider trading, market abuse)
- Although specific regulation for 'non sophisticated investors' in OTC derivatives markets (risk warnings), mostly carrying over from the FSA 1986. But caveat emptor for 'eligible counterparties' (Awrey 2011)
- Explosion in OTC derivatives transactions
- A network of 'anchors' for global capitalism replacing the Gold Standard? (Bryan & Rafferty 2006)
- Although there were other 'regulatory influences' (Basle, IAS etc). Most importantly ISDA product based regulation

OTC Derivatives Regulatory Space - Problems with Contracts



OTC Derivatives Regulatory Space - A Simple Standards Process?





Netting and Opinions – So What?

- Payment netting permits efficient transaction management between counterparties producing daily settlement figures
- But most important category is ‘close out netting’, permitting one single settlement figure on ‘termination event’ or ‘event of default’
- Close out netting can conflict with the spirit and substance of bankruptcy laws
- Now enjoys ‘safe harbour’ under Chapter 11 in US. Controversial systemic risk arguments. Also UK and elsewhere
- Position was less clear in other jurisdictions and legal traditions
- Netting opinions also important, especially where netting legislation does not exist. Similarly collateral opinions

ISDA – In the National State's Embrace

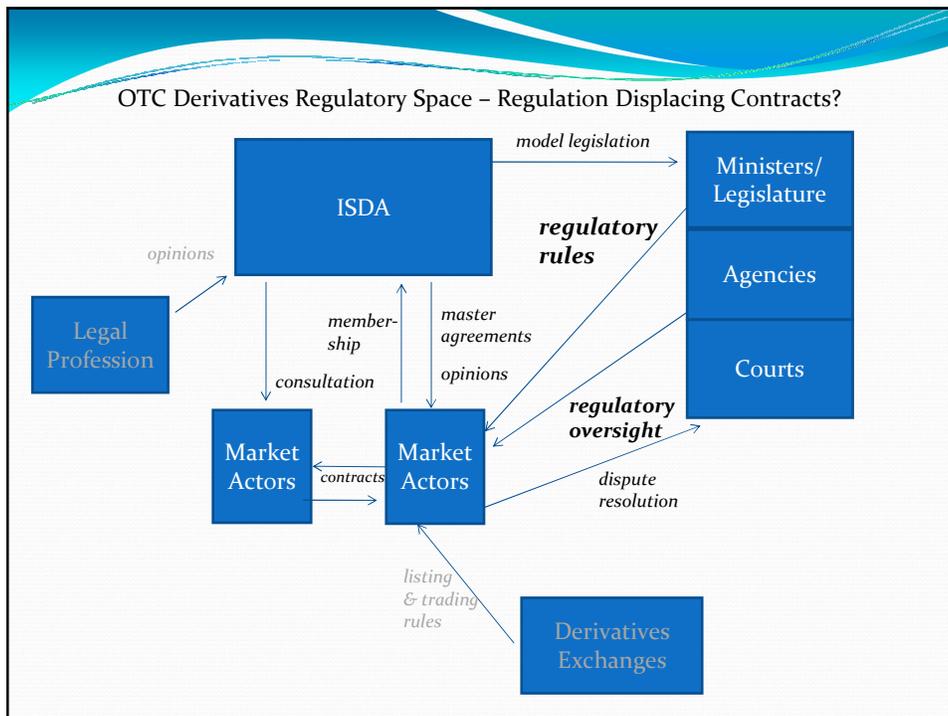
- ISDA is not an SRO
- But is also not a self contained private ordering regime similar to those described by Lisa Bernstein (1992, 2001) and Robert Ellickson (1986) either
- Perhaps the posting of collateral from the outset may obviate the requirement for interpersonal trust to maintain relationships between contracting parties (Riles 2008)
- Most significant, ISDA does not systematically reject state made law, it systematically *embraces* it in order to shore up its otherwise private contract based regime, for example through transposition of netting protection
- Governments transpose ISDA norms into national law but without mentioning ISDA itself. A sign that ISDA standards are very strong (Partnoy 2007)

Implications of the ISDA regime

- The ISDA regime appears efficient, at least for the dealers. Members actively choose to use Master Agreement
- From legitimacy standpoint could be seen as a form of technocratic expertise which is frequently mirrored by the role of independent experts public policy making (Cafaggi, Scott & Senden 2011)
- Or 'negotiated governance'. In public/private policy making 'public acceptability might derive from a variety of sources'. Efficacy and 'aggregate accountability' (Freeman 2000)
- In Ireland, the netting law was debated in parliament anyway, at least implicating democratic legitimacy (Schwartz 2002)
- In fact the very legitimacy of the concept of the State, understood through its monopoly in norms production, may demand actively assimilating such private norms rather than allowing them to operate as 'autonomous law' (Michaels 2003)

Implications of the ISDA Regime

- BUT it is not settled that close out netting exemptions are socially optimal, benefits may be largely internalised to derivatives dealers (Bergman et al. 2004).
- May be potential for serious negative externalities through increased systemic risk (Roe 2011, Lubben 2010, 2009; Bliss & Kaufman 2005)
- And in the case of purely speculative derivatives trading, whether netted and collateralised or not, we have observed the fallout for net social welfare in the wake of the GFC (Stout 2011)
- So the State legally shoring up activities which may be functionally analogous to straightforward gambling offers a legal respectability which may be highly questionable in a normative sense
- Therefore, the ability of powerful actors such as ISDA and their members to have their norms enshrined, which may not align with voter interests, may represent a manifestation of a 'democratic market failure' (Benvenisti 1999)



Conclusions: Private Regulation –

Forgotten But Not Gone?

- In the wake of the Global Financial Crisis it was decided to increase public oversight of OTC derivatives
- US Wall Street Reform and Consumer Protection Act
- EU Market Infrastructure Regulation/MiFID Review
- Aim to push much pre-existing OTC derivatives trading on to ‘designated contracts markets’ or swap execution facilities, through CCP’s and to record trades through trade repositories.
- Mostly EU/US. Not a significant imperative in Australia and Singapore. Canada on provincial basis (Quebec)
- New relationships, old outcomes? (accountability, governance)
- ISDA at the forefront working with legislators
- Implications? Adapting ‘private legal devices’? (Braithwaite 2011)

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