Brooklyn Law Review

Volume 77 | Issue 2 Article 5

2012

COMMENTARY ON THE ABRAHAM L. POMERANTZ LECTURE: Clearinghouse Governance: Moving Beyond Cosmetic Reform

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THE ABRAHAM L. POMERANTZ LECTURE

Clearinghouse Governance

MOVING BEYOND COSMETIC REFORM

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INTRODUCTION

The procedures that boards adopt in their decision-making processes raise uniquely interesting questions. In one of the most thoughtful modern critiques of the functional role of corporate boards, theorists Colin Carter and Jay Lorsche argue that three critical issues influence the effectiveness of boards' decision-making processes—time, knowledge, and information.[1] While each of the three elements merits careful consideration, conventional wisdom suggests that it is difficult, if not impossible, for boards to make rational business decisions if they do not allocate sufficient time to decision-making processes.[2] Recent popular accounts contradict the prevailing

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[1] COLIN B. CARTER & JAY W. LORSCH, BACK TO THE DRAWING BOARD 50-51, 67-68 (2003).

[2] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872-75 (Del. 1985). *But see* Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985) (strongly criticizing the majority opinion as "one of the worst decisions in the history of corporate law"). The Delaware legislature adopted a statutory provision permitting companies incorporated in Delaware to amend their corporate charters to exculpate directors from claims alleging that they breached their fiduciary duties by failing to adopt a sufficiently rigorous investigative process or a

presumption that dedicating more time to the decision-making process improves the quality of the ultimate decision.[3] In his *New York Times* best-selling account of the power of thinking, Malcolm Gladwell explains the countervailing view, arguing that decisions made in the *blink* of an eye may be as valuable as decisions characterized by months of rational analysis.[4]

Notwithstanding the accolades bestowed on Gladwell's contribution to the literature, not everyone finds his account persuasive. Dissecting Gladwell's arguments that extol the virtues of "snap" decision making, Frank Partnoy's recent article—"Don't Blink: Snap Decisions and Securities Regulation"—offers an insightful analysis of the significance of timing and careful reflection in decision-making processes.[5] Evaluating the convergence of increasingly complicated securities-trading technologies and complex financial products, Partnoy contends that boards may benefit from introducing a measured pace in their decision-making processes.[6] Examining precipitating decisions at financial institutions in the period preceding the recent financial crisis and the events of the flash crash that threatened financial markets in May 2010, Partnoy concludes that boards should introduce procedural reforms that deter "snap" decision making and introduce safeguards that institute a delay or "pause" in financial institutions' decision-making processes and financial intermediaries' operational processes.[7]

In addition to agreeing with Partnoy's suggestion that decision makers may benefit from deliberation and delay in their decision-making processes, this article argues that further procedural safeguards are necessary to protect the stability of financial institutions and financial intermediaries. Evaluation of the board's timeframe for making decisions forms part of a broader set of concerns regarding director accountability and institutional safeguards for risk-management oversight in the wake of the recent global financial crisis. In

reasonable due diligence process. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Within two years of the *Van Gorkom* decision, forty-two states had adopted similar exculpation clauses. *See, e.g.*, Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160-61 (1990).

3 *See, e.g.*, MALCOLM GLADWELL, BLINK: THE POWER OF THINKING WITHOUT THINKING 8 (2005).

4 *See id*.

5 *See generally* Frank Partnoy, *Don't Blink: Snap Decisions and Securities Regulation*, 77 BROOK. L. REV. 151 (2011).

6 *See generally id.*

7 *See generally id.*

order to ensure that boards fulfill risk oversight obligations, proposed regulatory reforms should effectively address the other issues that influence the board's ability to monitor, such as impartiality, expertise, and access to information.

To illustrate the importance of these governance safeguards, this article explores federal regulatory reform proposals in the over-the-counter (OTC) derivatives market. For more than two decades, commentators have encouraged regulators to adopt reforms that introduce a better regulatory framework in the OTC derivatives market.[8] During the recent crisis, a number of financial institutions experienced devastating losses related to their OTC derivatives portfolios.[9] In response, the federal government extended several hundred billion dollars in federal aid to these financial institutions.[10] The federal bailout prompted demands for federal regulatory intervention. Congress, in turn, adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[11] The newly minted legislation imposes greater transparency in the OTC derivatives market by requiring that market participants settle and clear eligible OTC derivatives transactions through registered derivatives clearinghouses.[12]

Notwithstanding the many benefits that clearinghouses engender, it is too early to celebrate the reforms' success. In order for clearinghouses to have the desired risk-reducing effects, reforms must reach the more complicated issues that challenge risk governance. Regulation must introduce procedural measures that reduce the conflicts of interest or cognitive biases that lead boards to adopt weak risk-management policies. Well-tailored governance safeguards are

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[8] *See, e.g.*, Remarks of Brooksley Born, Chairperson Commodity Futures Trading Comm'n, Fordham University School of Law 1999 Derivatives & Risk Management Symposium (Jan. 28, 1999), *available at* http://www.cftc.gov/opa/speeches/opaborn-42.htm; Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1023-32 (2007) (discussing the advocates who supported deregulation of off-exchange traded derivatives); andré douglas pond cummings, *Still "Ain't No Glory in Pain": How the Telecommunications Act of 1996 and Other 1990s Deregulation Facilitated the Market Crash of 2002*, 12 FORDHAM J. CORP. & FIN. L. 467, 530 (2007) (same).

[9] Mary Williams Walsh, *A.I.G., Still Troubled, Cuts Loss Sharply in First Quarter*, N.Y. TIMES, May 8, 2009, at B1.

[10] David M. Herszenhorn, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1.

[11] *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[12] *Id. But see* Gretchen Morgenson, *3,000 Pages of Financial Reform, but Still Not Enough*, N.Y. TIMES, May 29, 2010, at B1.

necessary to ensure accountability for risk-management oversight and to prevent clearing requirements from inadvertently creating a new source of systemic risk.

This article examines proposed regulatory reforms in the OTC derivatives market, focusing on the Dodd-Frank Act's requirement for derivatives counterparties to register and clear eligible transactions through clearinghouses. While the introduction of clearing requirements engenders important risk-mitigating benefits, commentators have voiced concerns regarding the incentives that certain larger, prominent clearinghouse members may have to adopt weak risk-governance policies, or policies that limit access to clearinghouse membership. These concerns cast a shadow over the promise of reform. Regulators are moving quickly to address these concerns, but their proposed treatment is as disconcerting as the incomplete legislative approach. Regulators' proposed reforms—customary board composition and structural solutions to the agency costs and conflicts of interest that arise in corporate governance—may be misguided in the context of clearinghouses.

As Partnoy suggests, effective reforms must extend beyond conventional techniques and creatively address the timing element of decision making. We must consider mechanisms such as a required "pause" in the risk governance decision-making process. Because the debate regarding the final contours of regulatory guidelines continues, this article limits its purpose to outlining the origins of OTC derivatives, their role in the crisis, and the proposed legislative and regulatory efforts to address relevant concerns. Finally, this article underscores significant issues that regulators must consider as they engage in one of the most rigorous rule-making periods in the history of the federal regulation of financial markets.

I. CRISIS AND REFORM IN THE OTC DERIVATIVES MARKET

While many weaknesses in the regulation of financial markets contributed to the recent financial crisis, the absence of regulation in the OTC derivatives market has led to particularly significant concerns. Focusing on the role of credit default swaps (CDS) in the recent crisis, Section A argues that the lack of regulation in the OTC derivatives market created moral-hazard and systemic-risk concerns. Section B surveys the reforms Congress has adopted to address these concerns.

A. OTC Derivatives and the Financial Crisis

Tasked with exploring "how the world's strongest financial system came to the brink of collapse[,]"[13] the Financial Crisis Inquiry Commission narrowed this broad inquiry to one central question:

> *[H]ow did it come to pass that in 2008 our nation was forced to choose between two stark and painful alternatives*—either risk the total collapse of our financial system and economy or inject trillions of taxpayer dollars into the financial system and an array of companies, as millions of Americans still lost their jobs, their savings, and their homes?[14]

The Commission's inquiry highlights the moral-hazard and systemic-risk concerns that plagued financial markets for the last several years. The origin or genesis of the crisis, however, dates back at least two decades. In the twenty-year period prior to the recent financial crisis, financial institutions acquired unprecedented debt portfolios; during this period, the volume of debt products that financial institutions held increased from $3 trillion to $36 trillion.[15] Evidence suggests that, in pursuit of profits, financial institutions implemented highly leveraged business and investment strategies, meaning their exposure to debt obligations far exceeded the capital or collateral reserves available to satisfy those debt obligations.[16]

During the same period, consolidation in the financial services industry led to a high concentration of credit-related risks.[17] The small group of financial institutions participating in the origination and trading of higher-risk credit and debt investment products began to increase their roles as market makers and counterparties in the OTC derivatives market.[18]

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[13] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xvi (2011) [hereinafter FCIC REPORT].

[14] *Id*.

[15] *Id.* at xvii.

[16] *See* Lynne Dallas, *Short-Termism, the Financial Crisis and Corporate Governance* 14, 22, 32 (San Diego Legal Studies Research Paper Series, Paper No. 11-052, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1794190##.

[17] *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES: FIRST QUARTER 2010, at 1 (2010) ("Derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions.").

[18] As of March 2008, the top twenty-five commercial and investment banks in the United States held more than $13 trillion in credit default swaps, with J.P. Morgan Chase, Citibank, Bank of America, and Wachovia among the most active traders in credit default

Contemporaneously, the size of the OTC derivatives market increased markedly—growing from a notional amount of $95.2 trillion in 2000 to approximately $673 trillion in 2007.[19]

The absence of regulation fostered obscurity in the OTC derivatives market. In the late 1990s and early 2000s, legislators expressly rejected calls for regulatory oversight in the OTC derivatives market and adopted legislation exempting OTC derivatives from the regulatory purview of the Securities Exchange Commission and the Commodity Futures Trading Commission.[20] Critics argued that regulation would have been redundant because self-regulation and a spirit of "self-preservation . . . would shield [financial institutions] from fatal risk-taking."[21] Moreover, critics of regulation concluded that regulation would "stifle innovation."[22]

CDSs reallocate risk by spreading risk exposure across a group of creditors, thereby reducing the risk exposure that each individual creditor faces.[23] CDS agreements allow protection buyers to shift some percentage of the risk of an issuer's default on a debt obligation identified in the CDS agreement (covered debt obligation) to its counterparty in the

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swaps. Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME BUSINESS (Mar. 17, 2008), http://www.time.com/time/business/article/0,8599,1723152,00.html.

[19] FCIC REPORT, *supra* note 13, at 48.

[20] *See* Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swaps Commons*, 82 U. COLO. L. REV. 167, 175, 221-28 (2011) (explaining congressional legislative efforts to ensure that federal regulatory agencies lacked authority to exercise jurisdiction over OTC derivatives); FCIC REPORT, *supra* note 13, at 48-50 (discussing the effect of the adoption of the Commodity Futures Modernization Act of 2000); *see also id.* at xviii (examining the absence of regulation and weak self-regulatory measures, the FCIC explained that "[m]ore than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards").

[21] FCIC REPORT, *supra* note 13, at xviii; *see also* Edmund L. Andrews, *Greenspan Concedes Flaws in Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008, at B1; Jacob M. Schlesinger, *What's Wrong? The Deregulators: Did Washington Help Set Stage for Current Business Turmoil?*, WALL ST. J., Oct. 17, 2002, at A1 (explaining how CFTC Chair Brooksley Born was strongly criticized for attempting to investigate the need for regulation in the OTC derivatives market).

[22] *See* FCIC REPORT, *supra* note 13, at xviii; *see also* Schlesinger, *supra* note 21, at B1 ("[Treasury Secretary Robert Rubin] took seriously Wall Street's complaints that even the threat of regulation could void pending transactions. Mr. Greenspan believed that innovative derivatives were making the economy more efficient by providing companies with a hedge against financial fluctuations.").

[23] *See* Partnoy & Skeel, Jr., *supra* note 8, at 1023-27 (discussing the benefits of CDSs).

agreement—the protection seller.[24] Early proponents of CDSs praised the instruments for their risk-mitigating benefits.[25] Arguably, this reallocation of risk militates against systemic risk—the threat that one large debt issuer's default or several debtors' defaults may cripple a systemically significant financial institution or trigger a domino effect of losses, leading to broader market disruption or multiple insolvencies.[26]

While many financial institutions faltered during the crisis, American International Group, Inc.'s (AIG) notorious and unparalleled liquidity and solvency crisis prompted the government to intervene and extend unprecedented federal financial aid to the international insurance firm.[27] AIG's exposure to CDSs illustrates the concerns arising from financial institutions' increasing involvement in the OTC derivatives market.[28] In the early 2000s, AIG's Financial

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[24] *See, e.g.*, *id.* at 1023-24; Alan Greenspan, Chairman, Fed. Reserve, Remarks Before the Futures Indus. Ass'n, Boca Raton, Fla. (Mar. 19, 1999) (transcript available at http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm) (stating that "[b]y far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives").

[25] Alan Greenspan was one of the most outspoken senior regulators to endorse the risk-spreading benefits of credit derivatives. Alan Greenspan, Chairman, Fed. Reserve, Remarks by Chairman Alan Greenspan to the Federal Reserve Bank of Chicago's Forty-First Annual Conference on Bank Structure: Risk Transfer and Financial Stability (May 5, 2005) (transcript available at http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/default.htm) ("Two years ago at this conference I argued that the growing array of derivatives and the related application of more-sophisticated [sic] methods for measuring and managing risks had been key factors underlying the remarkable resilience of the banking system, which had recently shrugged off severe shocks to the economy and the financial system.").

[26] *See* Partnoy & Skeel, Jr., *supra* note 8, at 1023-32 (discussing the advocates who supported deregulation of off-exchange traded derivatives).

[27] For a description of the details of the AIG bailout, see Press Release, Fed. Reserve Bd. (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm (announcing bailout and explaining that failure of AIG would damage markets).

[28] Specifically, AIG's difficulties stemmed from its participation in the credit derivatives market. Credit derivatives are one class of OTC derivatives. The class of credit derivatives comprises two types of financial products, credit default swaps and collateralized debt obligations. Credit default swap agreements are bilateral contracts that allow parties to transfer risk, allowing a creditor to shift to a CDS counterparty some or all of the risk exposure related to a debt obligation (covered debt obligation) referenced in the contractual agreement. *See* Johnson, *supra* note 20, at 192-96. The covered debt issuer's default triggers the CDS counterparty's obligations (protection seller) to provide insurance-like protection on the covered debt obligation. The notional amount of an OTC derivatives transaction describes the par amount or face value of the bonds or debt instruments that comprise the covered debt obligations named in the agreement. *Id.* at 215 n.246 (citation omitted). The party who buys protection in a credit default swap agreement (protection buyer) faces two types of credit or default risks. The protection buyer faces the risk that the issuer of the covered debt obligation will default. *Id.* at 194. If the debt issuer defaults, the protection buyer looks to the protection seller to satisfy its obligations under the terms and mitigate losses related to

Products division (AIGFP) aggressively developed its position in the credit derivatives market.[29] Historical analysis of default rates on certain debt securities, such as residential mortgages, suggested a low probability of any significant losses on collateralized debt obligations composed of these debt instruments.[30] As a result, protection sellers presumed that CDS agreements offering protection against a decline in the value of collateralized debt obligations (CDO)—specifically CDOs that bundled residential mortgages—presented little risk exposure.[31]

In the company's 2002 annual report, AIG did disclose AIGFP's increasing participation in the credit derivatives business.[32] From 2003 to 2006, AIG's annual reports discussed OTC derivatives and included innocuous statements regarding participation in the credit derivatives market.[33] However, after

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the covered debt obligation. *Id*. Consequently, the protection buyer faces another level of credit risk, the threat that the protection seller will default on the terms of the CDS agreement. *Id.* at 206. This latter risk is referred to as counterparty risk. *Id*.

[29] Gretchen Morgenson, *A.I.G., Where Taxpayers' Dollars Go to Die*, N.Y. TIMES, Mar. 8, 2009, at BU1.

[30] Olufunmilayo B. Arewa, *Financial Markets and Networks—Implications for Financial Market Regulation*, 78 U. CIN. L. REV. 613, 618-20 (2009).

[31] *See* Johnson, *supra* note 20, at 215 n.248.

[32] *See, e.g.*, Am. Int'l Grp., Inc., Annual Report (Form 10-K), at 97-99 (Mar. 31, 2003), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012303003570/y65998e10vk.txt (discussing AIG's financial services) ("AIGFP enters into credit derivative transactions in the ordinary course of its business. The overwhelming majority of AIGFP's credit derivatives require AIGFP to provide credit protection on a designated portfolio of loans or debt securities."). Credit derivatives include CDS and collateralized debt obligations. For a description of collateralized debt obligations or securitization, see Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 984-86 (2009) ("The securitization process begins when a bank (referred to as the 'sponsor') transfers loans that it has originated, or purchased from others, to a special-purpose entity (SPE). The SPE is structured so that it will be shielded from potential claims arising out of the sponsor's bankruptcy. The SPE creates a loan pool (sometimes by combining the sponsor's loans with loans sold by other lenders), and the SPE sells that pool to a second SPE, typically organized as a trust. The role of the second SPE is to manage the loan pool and to issue ABS that confer rights to receive cash flows from the pooled loans. The second SPE (the 'SPE issuer') hires an investment bank (frequently an affiliate of the sponsor) to underwrite the sale of ABS to investors. After the underwriting has been completed, the proceeds paid by investors for the ABS are transferred to the sponsor in payment for the loans. Also, in many cases, the SPE issuer hires the sponsor to act as servicing agent for the securitized loans.").

[33] Am. Int'l Grp., Inc., Annual Report (Form 10-K), at 106 (Mar. 15, 2004), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012304003302/y92059e10vk.htm; Am. Int'l Grp., Inc., Annual Report (Form 10-K), at 180 (May 31, 2005), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012305006884/y03319e10vk.htm; Am. Int'l Grp., Inc., Annual Report (Form 10-K), at 52 (Mar. 16, 2006), *available at* http://media.corporate-ir.net/media_files/irol/76/76115/10K_06.pdf; Am. Int'l Grp., Inc., Annual Report (Form 10-K), at 63 (Mar. 1, 2007), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012307003026/y27490e10vk.htm.

the company began to suffer losses on its credit derivatives portfolio in 2007,[34] the tenor of the disclosure shifted dramatically. The 2007 annual report disclosures revealed AIG's exposure to a net notional amount of protection covering over $500 billion of debt products[35]:

Net Notional Amount (in billions)

Corporate loans	$230
Prime residential mortgages	$149
Corporate debt/Collateralized loan obligations	$70
Multi-sector collateralized debt obligations	$78
Total	$527

Market participants had become overconfident, treating the risk-mitigating benefits of CDSs as guarantees that insured against losses related to an issuer's default on a covered debt obligation.[36] As a result, market participants underestimated the risk of counterparty default; they failed to appreciate the danger that an issuer might default on its obligations related to a covered debt and, at the same time, that a protection seller might default on its obligations under the CDS agreement.[37] When default rates on subprime mortgages began to accelerate in 2007, the absence of minimal, conventional risk-monitoring and uniform collateral reserve requirements in the OTC derivatives market triggered a cascade of severe losses.[38]

Because market participants mistakenly perceived CDSs as guarantees that eliminated default risk, they reduced

[34] Am. Int'l Grp., Inc., Annual Report (Form 10-K), at 81 (Feb. 28, 2008) [hereinafter AIG 2007 Annual Report], *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012308002280/y44393e10vk.htm.

[35] *Id.* at 122.

[36] *See, e.g.*, Johnson, *supra* note 20, at 215-16.

[37] *Id.*; Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1; Serena Ng, *AIG, Goldman Unwind Soured Trades—Move on Mortgage Deals Leaves Insurer with Loss of About $2 Billion*, WALL ST. J., Apr. 12, 2010, at C1.

[38] FCIC REPORT, *supra* note 13, at xxiv.

demands for traditional risk-reducing safeguards, such as reserving sufficient collateral to offset losses.[39] Even when CDS agreements did include collateral requirements, their terms were often significantly relaxed.[40] By the time CDS counterparties began to question protection sellers' ability to satisfy CDS obligations in 2007, the market was already quickly unraveling.[41]

What motivated AIG executives to aggressively increase the company's credit derivative portfolio in the years prior to the financial crisis? Some theorists posit that executives at AIG and other financial institutions received lucrative compensation based on the fees that AIG earned on CDSs during the years prior to the wave of subprime mortgage defaults that began in 2007.[42]

As the Financial Crisis Inquiry Commission noted, "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences."[43] According to the conclusions in the Financial Crisis Inquiry Commission's report,

> dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis . . . . Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding . . . . [L]arge investment banks and bank

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[39] *See* Heather Landy, *Unregulated Market Faces Test as Corporate Defaults Pile Up*, WASH. POST, Oct. 20, 2008, at A9.

[40] Mollenkamp, *supra* note 37, at A1; Ng, *supra* note 37, at C1.

[41] Houman B. Shadab, *Credit Risk Transfer Governance: The Good, the Bad, and the Savvy*, 42 SETON HALL L. REV. (forthcoming 2012) (manuscript at 69-71), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1919922.

[42] Citigroup's experience underwriting CDOs similarly suggests that compensation arrangements rewarded executives for risk taking without imposing parallel consequences if risky decisions led to significant losses. *See* Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 62-64 (2011). The structure of compensation policies created incentives for executives and directors to take risk. *Id.* at 57. Citigroup tripled its CDO offerings, increasing the total of CDO securities issued from $6.28 billion in 2003 to $20 billion in 2005. *See, e.g.*, Eric Dash & Julie Creswell, *The Reckoning: Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, at A1, *available at* http://www.nytimes.com/2008/11/23/business/23citi.html. Citigroup received approximately $500 million in fees from its CDO offerings in 2005. *Id.* When residential mortgage default rates and foreclosures began to rise in 2007 and 2008, the decline in the value of Citigroup's CDO portfolio and inventory of traditional and subprime mortgage-related assets forced Citigroup to substantially write down its CDO inventory. *See* Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In re* Citigroup Inc. Shareholder Derivative Litigation, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 113, 18 (2010).

[43] FCIC REPORT, *supra* note 13, at xix.

> holding companies . . . focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products.[44]

In response to the announcement that "the first quarter of 2008 'brought [AIG]'s CDS portfolio to a cumulative $20.6 billion loss between October 2007 and May 2008,'" shareholders filed a derivative action alleging that directors breached their fiduciary duties by failing to effectively monitor the company's exposure to risk in the credit derivatives market.[45] Some have argued that the novel claims seeking to hold directors liable for failing to monitor risk offer a tool for balancing directors' accountability for risk oversight with their authority to make risk-management decisions for the company.[46] However, recent state court decisions indicate that plaintiffs face a high bar when pleading that directors breached their fiduciary obligations by failing to monitor risk exposure related to sophisticated financial products.[47]

As a result of limitations that exist under state fiduciary accountability standards, recently adopted federal regulations introduce additional reforms.[48] The Dodd-Frank Act introduces regulatory reforms intended to respond to concerns related to financial institutions' incentive-based compensation structures, conflicts of interest related to compensation, and concerns regarding the operational weaknesses in the OTC derivatives market.[49] In a separate project I address the former concerns.[50] This article outlines reform efforts addressing the latter concerns.

The recently adopted federal statute introduces an institutional mechanism—a requirement that market participants clear and settle eligible OTC derivatives contracts through federally authorized clearinghouses. The clearing requirement delegates primary risk-governing authority to an intermediary—OTC derivatives clearinghouses. While

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[44] *Id.* at xviii-xix.

[45] *See In re* Am. Int'l Grp., Inc. Derivative Litig., 700 F. Supp. 2d 419, 426, 433-34 (S.D.N.Y. 2010) (citations omitted).

[46] *See, e.g.*, Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 967-68 (2009).

[47] *See In re* Am. Int'l Grp., Inc. Derivative Litig., 415 F. App'x 285 (2d Cir. 2011).

[48] *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[49] *See* Johnson, *supra* note 20, at 240-42.

[50] *See, e.g.*, Johnson, *supra* note 42, at 56-57.

imposing clearing requirements on eligible OTC derivatives transactions creates a more transparent and more efficient market, delegating primary regulatory oversight to clearinghouses also raises certain risk-governance concerns.

B. The Road to Reform: Clearinghouses

Title VII of the Dodd-Frank Act requires OTC derivatives market participants to register OTC transactions with an information repository and to clear these transactions through registered derivatives clearing organizations (DCO) or clearinghouses.[51] Prior to the imposition of registration and clearing requirements, parties trading in the OTC derivatives market entered into private, bilateral contracts.[52] The Dodd-Frank Act assigns regulatory oversight of securities-related OTC derivatives and commodities-related OTC derivatives to the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), respectively.[53] Clearinghouses and exchanges are commonly used to register and clear other financial products.[54] Each registered clearinghouse will offer a platform for originating and trading OTC derivatives that comply with the federal agencies' final rules.[55]

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[51] Dodd-Frank Act §§ 723, 763, 124 Stat. at 1675-82, 1762-84.

[52] *See, e.g.*, Partnoy & Skeel, Jr., *supra* note 8, at 1021-22.

[53] Dodd-Frank Act §§ 723, 763, 124 Stat. at 1675-82, 1762-84.

[54] For historical reflections on the use of financial intermediaries for clearing and settlement services, see generally Alexander D. Noyes, *Stock Exchange Clearing Houses*, 8 POL. SCI. Q. 252, 256 (1893); *see also* Randall S. Kroszner, *Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearinghouses and Recent Over-the-Counter Innovations*, 31 J. MONEY, CREDIT & BANKING 596, 598-604 (1999).

[55] Clearinghouses began clearing OTC derivatives well before the financial crisis. During the crisis when it became apparent that regulation was imminent, financial intermediaries petitioned regulatory agencies for formal authorization and acknowledgement of their authority to clear and settle OTC derivatives transactions. The CFTC has cleared eight companies as clearinghouses with one company's registration pending. *See* Press Release, Commodity Futures Trading Comm'n, CFTC Grants CME Clearing Europe Limited Registration as a Derivatives Clearing Organization (Sept. 6, 2011); Press Release, Commodity Futures Trading Comm'n, CFTC Grants ICE Clear Europe Limited Registration as a Derivatives Clearing Organization (Jan. 25, 2010); Press Release, Commodity Futures Trading Comm'n, CFTC Grants New York Portfolio Clearing, LLC Registration as a Derivatives Clearing Organization (Feb. 1, 2011); *In re* London Clearing House, Order of Registration (2001); *In re* Minneapolis Grain Exchange, Inc., Order of Transfer of Derivatives Clearing Organization Registration (2010); *In re* Natural Gas Exchange, Inc., Order of Registration (2008); *In re* North American Derivatives Exchange, Amended Order of Registration (2010); *In re* The Options Clearing Corporation, Order of Registration (2001); Press Release, Commodity Futures Trading Comm'n, CFTC Requests Public

The Dodd-Frank Act reflects Congress and regulators' perception that centralized clearing will "foster greater efficiencies . . . and promote transparency" in the OTC derivatives markets.[56] A clearinghouse functions as a central counterparty, agreeing to act as an intermediary for all transactions that are cleared and settled on its platform.[57] As a central counterparty, the clearinghouse agrees to act as a buyer in each transaction in which a clearinghouse member seeks to enter into a contract as a seller.[58] When a clearinghouse member seeks to enter into a transaction as a seller, the clearinghouse agrees to act as a buyer.[59] By standing in the middle, the clearinghouse becomes the counterparty for each transaction executed on its platform.[60]

Clearinghouses offer market participants many benefits. Similar to the benefits of an exchange, the introduction of a clearinghouse lowers spreads and transaction costs for users and enhances price discovery.[61] Clearinghouses facilitate loss mutualization,[62] credit-risk homogenization,[63] and multilateral netting,[64] improving market efficiency.[65]

Clearinghouses reduce the risk of counterparty default. By acting as an intermediary in each agreement that is

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Comment on an Application by Eurex Clearing AG for Registration as a Derivatives Clearing Organization (Sept. 29, 2011).

[56] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,885 (proposed Oct. 26, 2010) (to be codified at 17 C.F.R. pt. 242).

[57] *Id.*

[58] *See* Robert R. Bliss & Chryssa Papathanassiou, Derivatives Clearing, Central Counterparties and Novation: The Economic Implications 19-24 (Mar. 8, 2006) (unpublished manuscript), *available at* http://www.ecb.int/events/pdf/conferences/ccp/BlissPapathanassiou_final.pdf.

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] As described above, the organizational documents of clearinghouses provide for the clearinghouse to maintain reserves to provide sufficient assets to cover any clearinghouse member's default on contractual obligations. In addition, the clearinghouse also has authority to seek additional capital contributions if the losses related to a member's default exceed reserves. *See, e.g.*, Craig Pirrong, The Economics of Clearing in Derivatives Markets: Netting, Asymmetric Information, and the Sharing of Default Risks Through a Central Counterparty 26 (Jan. 8, 2009) (unpublished manuscript) (on file with the University of Houston Department of Finance), *available at* http://www.cba.uh.edu/spirrong/clearing_organization.pdf.

[63] Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49 (2011).

[64] *See, e.g.*, Pirrong, *supra* note 62, at 26.

[65] *Id.*

registered, cleared, and settled on its platform, the clearinghouse mitigates members' exposure to the risk of another member's default.[66] Because the clearinghouse is the central counterparty to each transaction, members no longer face the risk that counterparties will default on their contractual obligations.[67] In addition to its services as a matchmaker—pairing trade requests from members—the clearinghouse also agrees to act as a guarantor for transactions executed on the clearinghouse platform.[68] Consequently, the clearinghouse must adopt effective risk-management policies that vigilantly monitor members' abilities to satisfy obligations related to transactions executed on its platform.

Traditionally, clearinghouses employ several strategic risk-management mechanisms to ensure that members satisfy their contractual obligations.[69] Clearinghouses establish collateral and margin requirements that provide a means for the clearinghouse to mitigate a member's default.[70] Clearinghouses periodically evaluate members' credit quality and require members to contribute to a reserve fund or, in the event of a liquidity crisis, to contribute capital to preserve the solvency and integrity of the clearinghouse. As a result, the clearinghouse insulates each member from the risk that another member will default on obligations cleared and settled on the clearinghouse platform.[71]

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[66] *Id*. at 17, 22-25; *see, e.g.*, *id.* at 3-5 (arguing that the clearinghouse will only offer these benefits in markets that reflect conditions of complete information, but noting that market conditions, asymmetries of information, incentives to shift costs and distributive effects on pricing of default risk may increase systemic risk); *see also* Robert R. Bliss & Robert S. Steigerwald, *Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures*, 30 ECON. PERSP. 22, 24-26 (2006).

[67] *See* Bliss & Steigerwald, *supra* note 66, at 25 ("Credit risk, on the other hand, is centralized in the CCP itself"). Generally, clearinghouses only enter into matching transactions, meaning a clearinghouse will enter into an agreement with a member (Member A) acting as a protection seller only if the clearinghouse has already identified another member (Member B) who agrees to enter into a contemporaneous arrangement whereby the clearinghouse assigns its rights and obligations as a protection seller in the agreement with Member A to Member B. By matching transactions and substituting members into its positions in agreements clearing and settling on its platform, the clearinghouse minimizes its exposure to counterparty default risk. *Id.* at 24 ("A [clearinghouse] can be defined as '[a]n entity that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer.'" (citation omitted)).

[68] *See id.* at 24-25.

[69] *See id*. at 25.

[70] *See id.*

[71] *See* Squam Lake Working Grp. on Fin. Regulation, *Credit Default Swaps, Clearinghouses, and Exchanges* 4 (Council on Foreign Relations Working Paper, 2000),

On the one hand, clearinghouses will likely have the effect of reducing systemic risk by interposing a central counterparty in each derivatives transaction. The introduction of clearinghouses alleviates concerns that one of the two counterparties to a derivatives agreement will default on its obligations.[72] On the other hand, clearinghouses concentrate default risk. If the clearinghouse inaccurately assesses the creditworthiness of a member and the member defaults on its obligations, the clearinghouse may incur a loss.[73] Significant errors in setting margin and collateral obligations may ultimately cause the clearinghouse to become insolvent.[74] Having the clearinghouse act as the backstop for all agreements cleared on its platform creates concerns that a systemically significant financial institution may default, causing extensive losses that bankrupt the clearinghouse.[75] The potential bankruptcy of a clearinghouse creates systemic risk concerns. After agreements migrate from the private, bilateral market to clearinghouses, the threat of systemic risk shifts from a concern that a systemically significant financial institution (or series of systemically significant financial institutions) might fail, to the threat that the clearinghouse may face a liquidity crisis. In the event of a clearinghouse failure, the government might be compelled to extend funds to bail-out the clearinghouse to prevent a wave of losses across the industry. Thus, rigorous risk-management policies serve a critical role in the clearinghouse's success and, by extension, the successful mitigation of systemic risk.[76]

II. THE LIMITATIONS OF REFORM: CLEARINGHOUSES ARE NOT A PANACEA

While the clearing requirements imposed by the Dodd-Frank Act offer a safeguard that enhances risk oversight in the operational framework of the OTC derivatives market, there are concerns that the legislation offers too little guidance regarding clearing organizations' internal risk governance policies. As a consequence of the mandatory clearing

available at http://www.cfr.org/financial-crises/credit-default-swaps-clearinghouses-exchanges/p19756.

[72] *See generally* Bliss & Steigerwald, *supra* note 66.

[73] *See id.* at 25.

[74] *See id.*

[75] *See id.*

[76] *See generally id.*

requirement, all eligible transactions must be executed on the platform of one of the few authorized clearinghouses. Currently only a handful of clearing businesses have received authorization to clear and settle OTC derivatives transactions. Ironically, the transition from private, bilateral agreements to an organized, more transparent market may have the effect of concentrating risk in OTC derivatives markets. Thus, the limited competition in the clearing industry may concentrate risk and perpetuate systemic risk concerns.

In addition to concerns about effective risk management in the operational framework of the OTC derivatives market, there are fundamental concerns regarding the concentration of decision-making authority within the internal governance structure of authorized clearinghouses. A small number of systemically significant financial institutions or large dealers exercise voting control in the few authorized clearinghouses. Large dealers have voting control and the authority to elect directors who decide the clearinghouses' risk-management policies. When the commercial interests of these large dealers diverge from the clearinghouse's commercial interests or the normative legislative goals of the Dodd-Frank Act, a new set of systemic risk concerns emerges. In effect, this arrangement places decision-making authority regarding the internal risk-management policies of OTC derivatives clearinghouses in the hands of institutions whose internal risk oversight failures related to OTC derivatives products triggered a global economic recession.

A. *Clearinghouse Governance*

A clearinghouse may be a privately owned business that is closely held by members who exercise complete voting control over the governance and affairs of the business. Alternatively, a clearinghouse may be a company (or the subsidiary of a company) whose shares are publicly traded on a national securities exchange.[77] In either case, internal policies

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[77] *See* CME Grp., 2010 Annual Report 5 (2010) (CME Group is the parent company of CME Clearing Europe Ltd.); Intercontinental Exchange, Inc., 2010 ANNUAL REPORT 4 (2010) (ICE is the parent company of ICE Clear Europe Ltd. ICE's customers include "corporations, manufacturers, utilities, commodity producers and refiners, professional traders, financial institutions, institutional and individual investors and governmental bodies."); *Frequently Asked Questions*, N.Y. PORTFOLIO CLEARING, http://www.nypclear.com/faqs (last visited Oct. 14, 2011) ("How is the company structured? NYPC is a 50-50 joint venture between the DTCC and NYSE Euronext."); LCH.CLEARNET, http://www.lchclearnet.com/ (last visited Oct. 14, 2011) (LCH Clearnet is an independent company which "is owned 83% by its clients and 17% by [the] exchanges."); Minneapolis

may limit nonmembers' access to the clearinghouse's services.[78] Generally, nonmember firms may only clear or settle transactions through a clearinghouse if a member agrees to serve as an intermediary and executes the transaction on behalf of the nonmember.[79] What motivates such preferential treatment for members?

Members agree to be subject to periodic credit evaluations, to make capital contributions, and to maintain collateral and margin accounts to satisfy trading obligations.[80] Members also agree to contribute to a reserve or guarantee fund designed to ensure that the clearinghouse remains solvent if a member defaults on a large contract obligation and its margin account is insufficient to cover the loss, or if several members default on multiple contract obligations and their margin accounts contain less collateral than the amount of their losses.[81]

Investing in a clearinghouse affords members the authority to develop, implement, and enforce the governance measures of the clearinghouse. This authority permits members to determine the criteria for membership; it also allows members to establish collateral and margin policies (and policies regarding the contributions for reserves or a guarantee fund), clearing and settlement policies, and risk-management policies.[82] However, clearinghouse members' interests may be

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Grain Exchange, Inc., MGEX BROCHURE (2011), *available at* www.mgex.com/documents/MGEXFOLDER_versZE.pdf (MGEX is made up of 399 members in addition to the board of directors. "Memberships are bought and sold between individuals and firms with supply and demand affecting prices."); *Frequently Asked Questions*, NATURAL GAS EXCHANGE, INC., http://www.ngx.com/trading_faq.html (last visited Oct. 14, 2011) ("Who owns NGX?" NGX is wholly owned by TSX Group); *see also* TMX Grp., First Quarter 2011 Report to Shareholders 60 (2011) (description of the earnings per share)); *About Us: IG Group*, NORTH AMERICAN DERIVATIVES EXCHANGE, INC., http://www.nadex.com/trade/ig-group.html (last visited Oct. 14, 2011) (Nadex is fully backed by IG Group which is a publicly traded company on the London Stock Exchange.); Options Clearing Corporation, 2010 Annual Report 12 (2010) (OCC's membership consists of "130 of the largest U.S. broker-dealers, U.S. future commission merchants, and non-U.S. securities firms. . . . The stockholder exchanges share equal ownership of OCC."); *Company Profile*, EUREX CLEARING AG, http://www.eurexclearing.com/about/company_profile_en.html (last visited Oct. 14, 2011) (Eurex is a wholly owned subsidiary of Eurex Frankfurt AG and a public company.)

[78] *See* EUROPEAN CENT. BANK, CREDIT DEFAULT SWAPS AND COUNTERPARTY RISK 52 (2009), *available at* http://www.ecb.int/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf.

[79] *Id.*

[80] DARRELL DUFFIE ET AL., FED. RESERVE BANK OF N.Y., STAFF REP. NO. 424, POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE 21 (2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr424.pdf (discussing resort to capital base).

[81] *Id.*; *see also* Kress, *supra* note 63, at 63.

[82] Bliss & Steigerwald, *supra* note 66, at 25 (discussing counterparty credit risk management techniques).

strikingly diverse and certain members' interests may diverge from the collective profit-maximizing, risk management, or long-term stability-oriented interests of the broader group of clearinghouse members. Members' authority to determine clearinghouse governance policies engenders a distinct set of risk-management concerns.

Large dealers may exert influence through the election of clearinghouse board members and the appointment of board members to particular board committees. Board members and committees controlled by larger dealers will establish policies that affect the following: clearinghouses' collateral requirements, capital reserve requirements for margin accounts, or credit-quality standards used to assess eligibility for membership and clearing eligibility standards.

Large dealers have incentives to limit smaller dealers' access to clearinghouse membership. When large dealers act as brokers for the smaller nonmember dealers, the larger dealers earn revenues for executing transactions for dealers who are nonmembers and ineligible for membership. If eligibility standards preclude smaller dealers from gaining the full benefits of membership, then small dealers who desire to execute transactions must seek the assistance of the larger dealers who are members. Thus, large dealers have commercial incentives to ensure that smaller dealers remain ineligible for membership. Prior to the adoption of the Dodd-Frank Act, large dealers earned significant profits from the fees that they received for executing transactions on behalf of smaller dealers.[83]

Restricting clearinghouse membership based on the size of a transaction or the volume of deals that a dealer executes ensures that smaller dealers must arrange for larger dealers to serve as brokers.[84] This dynamic reflects one conflict of interest that large dealers face. This conflict portends that rent-seeking

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[83] *See* Christine Harper et al., *Wall Street Stealth Lobby Defends $35 Billion Derivatives Haul*, BLOOMBERG (Aug. 30, 2009), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agFM_w6e2i00; *see also* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,882, 65,8845 (proposed Oct. 26, 2010) (to be codified at 17 C.F.R. pt. 242).

[84] *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,882, 65,886 ("Participants may seek to limit the number of other direct participants in a security-based swap clearing agency in order to limit competition and increase their ability to maintain higher profit margins.").

behavior may undermine the Dodd-Frank Act's efforts to enhance transparency and mitigate systemic risk.

Similar to concerns regarding large dealers' incentives to place anticompetitive limits on small dealers' access to clearinghouse membership, commentators argue that large dealers with rent-seeking motives may urge boards to adopt policies that restrict the classes or volume of transactions that may be executed on clearinghouse platforms.[85] Members who exercise voting control over clearinghouses have incentives to minimize the products that the clearinghouse deems eligible for clearing.[86] The Dodd-Frank Act exempts contracts that are not eligible for clearing from mandatory registration and clearing requirements.[87] When clearinghouses adopt restrictive clearing criteria, fewer products are eligible to be cleared. If clearinghouse policies permit discriminatory eligibility criteria, then a large volume of transactions will continue to occur in a private, bilateral market. As a result, a significant volume of transactions will remain in the shadows of the market. Consequently, the effectiveness of mandating clearing through clearinghouses will be undermined and the opacity in the secondary market will weaken industry-wide systemic risk-management efforts.

Large dealers who control clearinghouse governance have incentives to adopt very narrow clearing eligibility criteria. By limiting the types of transactions that are eligible for clearing through the clearinghouse, large dealers may artificially restrict the volume of transactions that will be subject to the clearing requirements under the Dodd-Frank Act.[88] Clearinghouses,

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[85] For a discussion regarding larger dealers' commercial interests that may be divergent from the interests of clearinghouse shareholders (owners) or smaller dealers' interests in minimizing trading costs, see, for example, DUFFIE ET AL., *supra* note 80, at 10 ("[D]ealers have an incentive to maintain the wider bid-ask spreads that they can obtain in the OTC market . . . . Thus, from the viewpoint of their profits, dealers may prefer to reduce the migration of derivatives trading from the OTC market to central exchanges.").

[86] *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,887.

[87] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 763(a), 124 Stat. 1376, 1762 (2010).

[88] SEC/CFTC Joint Roundtable, CFTC-SEC Staff Roundtable on Clearing of Credit Default Swaps 48-49 (Oct. 22, 2010) (statement of Kristin Johnson) [hereinafter Johnson, Comments] (a roundtable to assist the agencies in the rulemaking process to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act). *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing

controlled by private members with diverse commercial objectives, will determine clearing eligibility policies.[89] All the transactions that a clearinghouse refuses to clear and settle will be executed in the private market where a large dealer will likely earn fees for facilitating these transactions.

Large members' control over clearinghouse board decision-making processes creates additional risk management concerns. Many of the large dealers who will exercise control over clearinghouse voting interests are financial institutions subject to regulatory capital requirements.[90] These members have significant incentives to encourage the adoption of policies that reduce the amount of collateral that must be reserved in their clearinghouse margin accounts or to overvalue the collateral maintained in margin accounts.[91] If the margin and collateral policies are ineffective, there will be insufficient funds to cover the losses if a member defaults.

Commentators have argued that the concerns described above threaten to undermine the clearing mandate.[92] Congress adopted the Dodd-Frank Act to enhance transparency in the OTC derivatives market.[93] The provisions of Title VII of the

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Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,882, 65,890.

[89] Section 763(a) adds new Section 3C(d)(3)(A) to the Exchange Act, which prohibits the Commission from requiring any clearing agency to accept a security-based swap for central clearing. *See* Dodd-Frank Act § 763(a), 124 Stat. at 1764.

[90] *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,890.

[91] *See id.* at 65,887.

[92] This article identifies several critical risk management concerns that arise from members' anticompetitive incentives or conflicts of interest. Several ancillary issues generate similar concerns. For a more detailed treatment of the risk management concerns arising from clearinghouse governance policies, see Sean Griffith, Incentive Problems in Derivatives Trading: Towards a New Corporate Governance Structure for Clearinghouses 24 (unpublished manuscript) (on file with the author) and Rena S. Miller, Cong. Research Serv., R 41715, Conflicts of Interest in Derivatives Clearing 5-6 (Mar. 22, 2011) (unpublished manuscript) (on file with the Cornell University ILR School), *available at* http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1832&context=key_workplace.

[93] Representative Barney Frank stated:

> The purpose of this in part is to get many more derivatives cleared. But the clearing houses have the right to refuse them if they say the transactions aren't suitable for clearing. We believe that some banks have an interest in not having them cleared. So we don't want entities that have an interest and [sic] there being no clearing, owning the clearing houses. That's why this is an important amendment to us, and it was passed after considerable debate on the House floor.

Dodd-Frank Act plainly aim to increase the volume of OTC derivatives transactions cleared on clearinghouse platforms.[94] Influenced by conflicts and self-interested incentives, clearinghouse members' decisions may ironically engender—rather than reduce—risk. Without formal governance safeguards, clearinghouses will not serve as the gatekeepers in OTC derivatives markets that Congress and regulators envision. While the introduction of clearinghouses alleviates some concerns regarding systemic risk in OTC derivatives markets, the imposition of clearing requirements without sufficient internal governance controls offers an incomplete solution. Procedural safeguards are necessary to ensure that these conflicts of interest and self-interested incentives do not undermine the risk-reducing framework that the Dodd-Frank Act introduces. These safeguards should address anticompetitive incentives that would disadvantage smaller dealers and reduce the volume of transactions subject to clearing requirements as well as promote appropriate risk management policies to ensure that the clearinghouse remains sufficiently liquid and solvent.[95]

B. Proposed Rules to Address Clearinghouse Governance and Reduce Systemic Risk

Concerns regarding clearinghouse members' commercial incentives and conflicts of interest have incited a rigorous debate among market participants, regulators, and commentators.[96] Prior to the adoption of the Dodd-Frank Act, legislators did consider adopting statutory language that would have ensured balanced participation in clearinghouse governance.[97] Congressional debate prior to the adoption of the final language of the Act reflects commentators' concerns that

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Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,887 n.39 (quoting House-Senate Conf. Comm. Holds Markup on HR 4173, Financial Regulatory Overhaul Bill, June 24, 2010, *reprinted in* CQ Congressional Transcripts, 111th Cong. 182 (2010) (statement of Barney Frank, Chairman, House Comm. on Fin. Servs.)).

[94] Miller, *supra* note 92, at 3-4.

[95] Johnson, Comments, *supra* note 88, at 48-49.

[96] Griffith, *supra* note 92, at 21.

[97] *See, e.g.*, H.R. REP. NO. 111-370, at 188-92 (2009).

clearinghouse members' self-interest might undermine operational safeguards designed to reduce risk.[98]

For example, Representative Stephen Lynch proposed an amendment to the working bill in the House of Representatives suggesting that the bill include language addressing members' incentives to restrict access to membership.[99] The "Lynch Amendment" proposed limiting the voting interest of large dealers and imposing governance requirements designed to ensure that a majority of the members of the clearinghouse boards were independent.[100] While the Lynch Amendment was not incorporated in the legislation,[101] the enacted statute does include language that empowers federal regulatory agencies to adopt rules addressing concerns regarding members' incentives to restrict clearing eligibility and for clearinghouse membership.[102] Acting pursuant to the express authorization extended in Title VII of the Dodd-Frank Act, regulators have proposed governance measures that aim to address large dealers' conflicts of interest and their incentives to favor weak risk governance policies.[103]

In October 2010, the SEC and the CFTC proposed rules to address risk governance concerns.[104] Employing board composition measures similar to the reforms adopted in the Sarbanes-Oxley Act and provisions of the Dodd-Frank Act that enhance the risk-governance policies within publicly traded

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[98] *See id*.

[99] *See id*.

[100] *Id*.

[101] Miller, *supra* note 92, at 6.

[102] *Id*.

[103] *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,882, 65,896 (proposed Oct. 26, 2010) (to be codified at 17 C.F.R. pt. 242).

[104] Both the CFTC and the SEC proposed rules in October 2010. *See* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63,732 (proposed Oct. 18, 2010); Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest, 76 Fed. Reg. 722 (Jan. 6, 2011); Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,895. In March 2011, the federal regulatory agencies released statements indicating that they were reopening the ninety-day comment period on the proposed rules. As of the date that this article is printed, the regulatory agencies have not adopted interim or final rules.

companies,[105] the proposed rules suggest substantive corporate governance reforms.[106] The proposals suggest two alternative approaches designed to ensure that clearinghouse boards are not controlled by a few dominant market participants—voting caps and board composition requirements.[107]

The SEC describes the first approach as the "Voting Interest Focus Alternative."[108] Consistent with its title, the Voting Interest Focus Alternative creates individual and aggregate ownership limits for specified entities[109]—a group of the larger swap dealers and banks engaging in swap transactions. Under the Voting Interest Focus Alternative, a specified entity is prohibited from beneficially owning more than 20 percent of the voting interests in the clearinghouse.[110] In addition to this limit on each individual clearinghouse member's voting interests, the proposed rule prevents specified entities from beneficially owning more than 40 percent of the

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[105] For a discussion of Sarbanes-Oxley and Dodd-Frank Act reforms, see *supra* notes 10-12 and accompanying text.

[106] *See* Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest, 76 Fed. Reg. at 722, 723 nn.8-9 (citing section 726(a) of the Dodd-Frank Act, codified at 15 U.S.C. § 8323(a)); Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 65,883.

[107] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,894-903; Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at 63,737-44.

[108] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,894.

[109] Under section 765(a) of the Dodd-Frank Act, the SEC is authorized to adopt rules that create numerical limits on the voting control of "Specified Entities," which include bank holding companies with consolidated assets of $50 billion or more, a nonbank financial company, an affiliate of a bank holding company or nonbank financial company, a security-based swap dealer, or a major security-based swap participant. *Id.* at 65,883. A parallel provision under section 726(a) of the Dodd-Frank Act authorizes the CFTC to adopt rules limiting the voting control of Enumerated Entities. Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest, 76 Fed. Reg. at 723 nn.8-9 (citing section 726(a) of the Dodd-Frank Act, codified at 15 U.S.C. § 8323(a)).

[110] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,894.

aggregate voting interests of a clearinghouse.[111] The aggregate limit "restrict[s] participants' ability to collectively acquire a majority voting interest."[112] Under the second approach—the "Governance Focus Alternative"—no clearinghouse member or specified entity may own more than 5 percent of the voting interests in a clearinghouse.[113] The Governance Focus Alternative's smaller limit on voting control is not coupled with an aggregate voting limit.[114] The voting limitations aim to address concerns that large dealers will encourage the adoption of anticompetitive membership and clearing eligibility policies.

To ensure the effectiveness of clearinghouses' risk governance policies, the proposals impose board composition and board committee obligations.[115] Under the Voting Interest Focus Alternative, the proposal limiting individual voting interest to 20 percent of the clearinghouse's voting interests and imposing an aggregate voting interest limit of 40 percent on specified entities, the clearinghouse must appoint independent directors to at least 35 percent of the board seats.[116] Under the Governance Focus Alternative with the smaller 5 percent voting limitation and no aggregate voting limit, the proposed rules require the clearinghouse to appoint independent directors to a majority of the seats on the board.[117] In addition to these board composition requirements, each proposal requires the board of the clearinghouse to establish a nominating committee, disciplinary panel, and risk-management committee.[118] The proposed board structural and

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[111] *Id.* at 65,895.

[112] *Id.*

[113] *Id.* at 65,900.

[114] *Id.*

[115] *Id.* at 65,896, 65,901-02.

[116] *Id.* at 65,896. The CFTC proposal requires "public directors," but defines public directors in a manner consistent with the SEC definition of "independent director." *See* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63,732, 63,742 & n.73 (proposed Oct. 18, 2010).

[117] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,901.

[118] Under the SEC's Voting Interest Focus Alternative, clearinghouses must appoint independent directors to at least a majority of the seats on the nominating committee. Under the Governance Focus Alternative only independent directors may be appointed to the nominating committee. *Id.* at 65,897, 65,901-02. Under the CFTC approval, the chair for the disciplinary panels must be a public director. Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. at

compositional requirements aim to serve as a critical "check against conflicts of interest."[119]

The spirit of these measures exemplifies the type of reform that Partnoy endorses in his analysis of the recent crisis. Partnoy encourages financial market intermediaries to incorporate a "pause" or delay in their deliberative processes.[120] While regulators' responses to the need for clearinghouse governance are laudable, the proposed reforms merely alter the composition of the board; the proposed reforms will likely be insufficient to address clearinghouse members' conflicts of interest and their incentives to act in manners contrary to regulatory goals. Several noteworthy problems undermine the presumption that the proposed board composition reforms will be sufficient to address the conflicts of interest and incentives described above. For example, the limited pool of qualified director candidates creates a persistent problem. In order to develop, implement and enforce effective risk management policies, clearinghouse boards will recruit from a small circle of experts and industry insiders. In this insular group, it is unlikely that there will be a large pool of truly independent candidates that lack material and relational ties to large dealers. While there may be candidates who qualify under the regulators' criteria, it is unlikely that candidates with appropriate qualifications will not have material ties to the dominant financial institutions acting as large dealers—or aspirations to develop ties after their prestigious appointments to clearinghouse boards.

Moreover, clearinghouses are self-regulatory organizations. Because they function as critical engines in the operation of financial markets, clearinghouses serve a unique public-private function. The effects of their services impact the broader economy. Yet these institutions are either closely held or publicly traded businesses that face demands from a diverse group of constituents. When members elect directors to serve on clearinghouse boards, the members—financial institutions

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63,740. The risk management committee requirements in the CFTC proposal offer greater details regarding the participation of public directors and include a requirement that at least 10 percent of the participants on the risk management subcommittee be customer representatives. *Id.* at 63,741-42.

[119] Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. at 65,896.

[120] *See generally* Partnoy, *supra* note 5.

and financial services intermediaries—generally nominate their own senior executives as candidates for clearinghouse board seats. These elected directors are then presumed to vote consistent with the commercial interests of the member institution that promoted their candidacy. These directors may find it difficult to serve their employers' commercial interests and support policies consistent with the clearinghouse's quasi-regulatory role. Significant risk governance concerns arise when members' proprietary interests diverge from the regulatory presumption that clearinghouses serve as an institutional safeguard against systemic risk or moral hazard.

C. *Improving Clearinghouse Boards' Decision-Making Processes*

Recalling the famous visual awareness experiments by Christopher Chabris and Daniel Simons, Frank Partnoy explains that one of the most significant issues in developing effective regulatory reform is identifying the "gorilla" in the room.[121] Exploring Chabris and Simons's claim that inattentional blindness can challenge even the most diligent observer, Partnoy offers several illustrations from the recent financial crisis that demonstrate the weaknesses in the decision-making processes of several highly sophisticated financial institutions.[122]

The special position that clearinghouses occupy in financial systems justifies regulatory oversight that ensures careful development of governance policies. These policies must include provisions that address challenges such as members' incentives to adopt anticompetitive membership and clearing eligibility criteria. For example, expanding the definition of independence offers one approach to encourage a more impartial dialogue in clearinghouse boardrooms. In addition, best practice standards and the proposed rules suggest that clearinghouse boards should create subcommittees focused on addressing risk-management concerns.

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[121] *See id.* at 162.

[122] *See generally id*; *see also* CHRISTOPHER CHABRIS & DANIEL SIMONS, THE INVISIBLE GORILLA: AND OTHER WAYS OUR INSTITUTIONS DECEIVE US 5-6 (2010). Chabris and Simons's experiment illustrates the challenge of perceiving an extremely odd event—a gorilla entering the room—when executing a specified task. *Id*. In conducting their experiment, they tasked subjects with counting the number of times that team members passed a basketball during a short video. *Id*. at 5. During the short video, a person in a full gorilla suit appears on the video screen. *Id*. at 6. Half of the subjects participating in the experiment did not see the gorilla. *Id*.

Combining these potential solutions, independent directors may offer invaluable contributions through their service on risk-management committees. Such committees would have significant autonomy to review and investigate risk-management concerns. The risk-management committee or its members must also play a significant role in the development of policies that may be within the purview of other committees whose decisions have significant risk management implications. For example, risk management committee members must participate in establishing standards for margin and collateral requirements.

An adaptive and engaging risk-management committee will improve the board's ability to anticipate and address risk-management issues that threaten the stability of the clearinghouse and pose systemic risk concerns. The directors appointed to this committee should not only lack material financial ties, but they should also have established expertise in managing clearinghouse or exchange risk; they should be capable of articulating weaknesses in proposed risk-management policies and evaluating such policies objectively.

To ensure the benefits of the recently enacted Dodd-Frank Act, risk-management committees should include a board member designated as the contrarian. This board member should raise alternative strategies and question the prevailing opinion.[123] Continuous critical evaluation of risk-management policies may lead to revelations about latent weaknesses.[124]

CONCLUSION

Creating procedural safeguards that delay decision-making processes, or instituting a "pause," may reduce concerns that members' self-interested incentives will dominate clearinghouses' risk-management decisions. The currently proposed voting limitations and board structure and composition reforms are likely insufficient to address these concerns. Even if the proposed voting limits and corporate-governance obligations are formally adopted, clearinghouses may fail to accomplish the statute's desired public policy effect. To truly impart reform, legislators and regulators must

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[123] *See* Troy A. Parades, *Corporate Decisionmaking: Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 741-47 (2005) (explaining that recent federal reforms are not a substitute for directly addressing psychological biases that motivate managers).

[124] *Id.*

address the cognitive biases and risk culture concerns that will likely permeate clearinghouses' risk-management policies.

Federal regulatory agencies must explore alternative remedies that address cognitive biases and their influence on risk-management decisions. This article suggests imagining creative solutions that reach beyond the common regulatory responses to traditional corporate governance. Reforms must introduce procedural safeguards that ensure that decision makers "pause" in their deliberative processes. For most boards, incorporating a sufficiently rigorous procedural mechanism offers a valuable addition to their decision-making process and enhances governance. However, in the context of clearinghouse boards, such procedural mechanisms may be critical to ensure boards adopt sufficiently rigorous risk management policies. The suggested internal procedures create a type of "pause" that enables decision makers to better manage the risks they face and, consequently, reduce the threat of systemic risk and prevent future crises.