

The New York State Insurance Department and Credit Default Swaps: Good Intentions, Bad Idea

Given the diversity of the various federal proposals for the regulation of CDSs, the necessary delay in achieving consensus with respect to them, and the uncertainty of their enactment, the NYID's plan to treat CDSs as insurance contracts appears extremely attractive initially.

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Acting in the belief that the use and misuse of credit default swaps (CDSs) were in large part responsible for the extraordinary current financial crisis,¹ the New York State Insurance Department (NYID) on September 22, 2008, issued Circular Letter No. 19 (2008) ("Circular 19") announcing that as of January 1, 2009, it would view CDSs as insurance contracts if they are purchased by persons with a "material interest" in the referenced bonds or

assets (covered CDSs).² At the same time, the Governor of New York called on the federal government to regulate the rest of the massive \$62 trillion credit derivatives market.³

¹ With allegations that CDSs are at the root of the global financial crisis, gaps in CDS regulation have come into the spotlight. See Alex Blumberg, "Unregulated Credit Default Swaps Led to Weakness" (available at www.npr.org/templates/story/story.php?storyId=96395271); James B. Kelleher, "Buffett's 'time bomb' goes off on Wall Street," Reuters, September 18, 2008. Wolfgang Munchau, "Not Merely a Subprime Crisis," Financial Times, January 14, 2008 (available at [www.eurointelligence.com/index.php?id=581&type=98&tx_ttnews\[tt_news\]=1996](http://www.eurointelligence.com/index.php?id=581&type=98&tx_ttnews[tt_news]=1996)). As Eric Dinallo, Superintendent, NYID, said in addressing CDSs:

The unregulated marketplace in credit derivatives was a central cause of a near systemic collapse of our financial system. Credit default swaps played a major role in the financial problems at AIG, Bear Stearns, Lehman and

the bond insurance companies. A major cause of our current financial crisis is not the effectiveness of current regulation, but what we chose not to regulate.

"Testimony To The United States House Of Representatives Committee On Agriculture Hearing To Review The Role Of Credit Derivatives In The U.S. Economy" (by Eric Dinallo, Superintendent, New York State Insurance Department (November 20, 2008)) (www.ins.state.ny.us/speeches/pdf/sp0811201.pdf) (hereinafter "Dinallo Testimony"). See also Press Release, New York State Insurance Department, Recognizing Progress by Federal Government in Developing Oversight Framework for Credit Default Swaps, New York Will Stay Plan to Regulate Some Credit Default Swaps (November 20, 2008) (available at www.ins.state.ny.us/press/2008/p0811201.htm).

² New York State Insurance Department, Circular Letter No. 19 (September 22, 2008) (available at www.ins.state.ny.us/circltr/2008/cl08_19.pdf) (hereinafter "Circular 19").

³ Press Release, New York State Insurance Department, "Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation" (available at www.ins.state.ny.us/press/2008/p0809224.pdf) (hereinafter "Governor's Press Release"). "The absence of regulatory oversight is the principle cause of the Wall Street meltdown we are currently witnessing . . ." "The primary goal of insurance regulation is to protect policyholders by ensuring that providers of insurance are solvent and able to pay claims on policies they issue. The goal of regulating these swaps is not to stop sensible economic transactions, but to ensure that sellers have sufficient capital and risk management policies in place to protect the buyers, who are in effect policyholders." Id. "FGI policies on CDS have exposed FGIs to certain risks that they have proved ill-equipped to underwrite or otherwise address effectively. Recent experience has shown that guarantees of CDS for which the FGI uses an SPV as a nominal counterparty are not consistent with the prudent operation and regulation of an FGI." Circular 19, at 7.

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The NYID's claim of regulatory jurisdiction over covered CDSs was met with substantial skepticism and intense criticism. Nevertheless, New York's announcement appears to have prodded federal regulators to move forward more quickly with regulatory initiatives for the CDS market than they might otherwise have done. As a result, on November 20, 2008, the Superintendent of Insurance for the State of New York announced, in testimony before Congress, that because of these federal initiatives, the NYID would "delay indefinitely" its plan to regulate covered CDSs. The Superintendent made clear, however, that the NYID continued to view covered CDSs as insurance contracts that were subject to its regulatory authority whenever it might chose to exercise it.⁴

A discussion of the need for and the appropriate scope and nature of a comprehensive, sensible, and effective regulatory scheme for CDSs is beyond the scope of this article. The NYID's claim of regulatory authority over a substantial subset of the CDS market, however, has seriously complicated the achievement of such a regulatory scheme. Furthermore, the NYID's assertion that covered CDSs are insurance contracts has raised the serious issue of whether New York could classify other types of derivative contracts as insurance contracts. For example, if covered CDSs are insurance contracts, why not covered over-the-counter (OTC) options on assets of all sorts? Given the need and importance of a uniform and effective regulatory regime for CDSs and the mischief the NYID's proposal is likely to cause in achieving such a regime, an extended consideration of New York's claim that "covered" CDSs are insurance contracts appears to be called for.

This article's conclusions are straightforward: derivatives are not insurance; the NYID assertion of jurisdiction over CDSs is inappropriate; and federal plans to regulate the CDS market should proceed without regard for the NYID's claims of regulatory jurisdiction. Before setting out the arguments that support these conclusions, first CDSs should be described, and then the regulatory scheme in effect for CDSs and other OTC derivatives when the current financial crisis began and that remains in effect today should be summarized. The next two sections attempt to do just that.

CREDIT DEFAULT SWAPS

CDSs are the largest component of the credit derivatives market. Credit derivatives are bilateral contracts the value of which is linked to the credit status or

⁴ Press Release, New York Will Stay Plan, above. See also Dinallo Testimony.

value of a debt obligation or pool of debt obligations. At the end of 2007, according to the International Swap and Derivatives Association (ISDA), credit derivatives with a notional value of \$62.2 trillion were outstanding, and were the fastest growing part of the worldwide OTC derivatives market.⁵ Credit derivatives have been traded since 1992,⁶ and now include a variety of structured products all of which are designed to require a payment of some sort to one party—the credit protection buyer—from the other party—the credit protection seller—upon the decline in value of or a "credit event" involving the bonds or borrowings of a third party (the reference obligation),⁷ or a pool or portfolio of reference obligations.⁸ Payments under credit derivatives are calculated and made pursuant to the specific terms of the contracts creating them, but in all cases such payments are not tied to or dependent on the obligations, liabilities, or losses of the credit protection buyer.

If covered CDSs are insurance contracts, why not covered over-the-counter (OTC) options on assets of all sorts?

In a CDS, the protection buyer buys the "protection," either with a single up-front payment or a series of periodic payments (the premium or spread). The protection seller then pays the protection buyer if a credit event occurs. Neither the protection buyer nor the protection seller needs to have any actual credit exposure to or risk associated with the reference entity or reference obligation.⁹ Nor does the protection

⁵ With the financial crisis, the first half of 2008 has shown a dramatic reduction in the notional amount of the credit derivatives market. See ISDA, "ISDA Mid-Year 2008 Market Survey Shows Credit Derivatives at \$54.6 Trillion" (September 25, 2008) (available at www.isda.org/index.html: follow "Press" hyperlink; then follow "Press Releases (2008)" hyperlink); "DTCC Deriv/SERV Trade Information Warehouse Report" (available at www.dtcc.com/products/derivserv/data/index.php).

⁶ It has been reported that ISDA first used the term "credit derivatives" in 1992. Vinod Kothari, "Evolution of Credit Derivatives" (available at www.credit-deriv.com/evolution.htm).

⁷ Reference obligations are also referred to in discussions of credit derivatives as "reference assets" or "reference credits."

⁸ In fact, the 2003 ISDA Credit Derivatives Definitions simply define a "Credit Derivative Transaction" as "any transaction that is identified in the related Confirmation as a Credit Derivative Transaction or any transaction that incorporates these Definitions." ISDA, 2003 ISDA Credit Derivatives Definitions, § 1.1.

⁹ Banking or insurance regulations may require a bank or insurance market participant to own a reference obligation, but that is not a requirement for entering into a CDS.

buyer need to demonstrate a financial loss to collect the payment specified in the CDS contract from the protection seller.

Typical “credit events” specified in CDSs are a price deterioration (of a “material” amount) in a reference obligation coupled with one or more of the following: bankruptcy, cross-acceleration, rating downgrade, repudiation, moratorium, restructuring, or payment default.¹⁰ The payment due the protection buyer in such circumstances can vary, but is generally a cash payment equal to the notional amount of the contract in return for delivery of the reference obligation (physical settlement) or the notional amount minus the then current value of the reference obligation (cash settlement).¹¹

After enactment of the Commodity Futures Modernization Act, OTC derivative transactions that involved an underlying of any sort other than an agricultural product—thus all CDSs—were outside the CFTC regulatory reach as long as both counterparties were eligible contract participants.

CURRENT REGULATORY SCHEME FOR OTC DERIVATIVES

Prior to 2000, it was unclear whether OTC derivatives, including CDSs, should or could be regulated as (1) futures contracts or commodity options under the Commodity Exchange Act (CEA);¹² (2) securities or options on securities under the Securities Act of 1933 (33 Act)¹³ and the Securities Exchange Act of 1934 (34 Act)¹⁴ (and together with the 33 Act the Securities Acts); (3) “gambling” under state bucket shop prohibitions;¹⁵ or (4) something else altogether. In 2000, however, the Congress attempted to clarify the regulatory status of all OTC derivatives by enacting the Commodity Futures Modernization Act (CFMA).¹⁶

¹⁰ ISDA, 2003 ISDA Credit Derivatives Definitions, Art. IV (2003).

¹¹ For example, if after a credit event a reference obligation is valued at \$3 million, and the notional amount specified in the contract is \$10 million, the protection seller must pay the protection buyer \$7 million. Alternatively, the protection seller may be required to pay a predetermined sum (a “binary” settlement) regardless of the then value of the reference obligation.

¹² 7 U.S.C. 1 et seq.

¹³ 15 U.S.C. 77a et seq.

¹⁴ 15 U.S.C. 78a et seq.

¹⁵ See, for example, N.Y. CLS Gen. Bus. § 351.

¹⁶ PL 106-554, 114 Stat. 2763 (2000).

On the commodities side, the CFMA made extensive and far-reaching changes to the status of OTC derivatives under the CEA. The precise details of these changes are not important for purposes of this article, but the three big changes are the following. First, a new category of market participant—“eligible contract participant”¹⁷—was established. Essentially, eligible contract participants are major financial institutions, large corporations, pension plans, foundations, and individuals with substantial assets. Second, all “commodities,” as defined in the CEA,¹⁸ were divided into three types: “excluded,” “exempted,” and “agricultural.” And third, all “contracts, agreements, and transactions” between eligible contract participants that do not occur on an organized exchange—that is, that occur OTC—were excluded from (1) all substantive provisions of the CEA if they “involve” excluded commodities;¹⁹ (2) virtually all substantive provisions of the CEA if they “involve” exempt commodities;²⁰ and (3) none of the provisions of the CEA if they “involve” agricultural commodities.²¹

The net result of the CFMA’s changes to the CEA was entirely to remove from the CFTC’s jurisdiction “contracts, agreements, and transactions” between “eligible contract participants” in excluded and exempt commodities. In other words, after enactment of the CFMA, OTC derivative transactions that involved an underlying of any sort other than an agricultural product—thus all CDSs—were outside the CFTC regulatory reach as long as both counterparties were eligible contract participants.

On the securities side, the CFMA effected changes to the Securities Laws by amending the Gramm-Leach-Bliley Act (GLBA)²² in three significant ways. First, the CFMA added to GLBA the following definition of “swap agreement:”²³ any “agreement, contract or transaction”²⁴ between “eligible contract participants,”²⁵ the material terms of which “are subject to individual negotiation”²⁶ and that is, among other things, an option on “financial or economic interests

¹⁷ CEA § 1a(12).

¹⁸ CEA § 1a(4).

¹⁹ CEA § 1a(13).

²⁰ CEA § 1a(14).

²¹ CEA § 2(g).

²² PL 106-102, 113 Stat. 1338 (1999).

²³ GLBA § 206(A), 15 U.S.C. 78c (2008).

²⁴ GLBA § 206(A)(a), 15 U.S.C. 78c (2008).

²⁵ Id.

²⁶ Id.

or property of any kind;²⁷ a transaction dependent upon the occurrence of “an event or contingency”²⁸ associated with a “financial, economic, or commercial consequence”;²⁹ or an exchange on a fixed or contingent basis of payments based on the value of just about any thing. The only significant exception to this extraordinarily broad definition of “swap agreement” is for options “on any security.”³⁰ In other words, in general terms, swap agreements under the GLBA include all OTC derivative agreements and transactions except those involving options on securities.

Second, the CFMA specified that “swap agreements” as defined in the GLBA are not securities. Such swap agreements were then divided into “security-based swap agreements”³¹ and “non-security based swap agreements.”³² Security-based swap agreements—swap agreements a material term of which is based on the price, value, or volatility of any security or group or index of securities³³—are made subject to all of the anti-fraud, anti-manipulation and anti-insider trading provisions of the Securities Acts to the same extent they would be if they were securities.³⁴ Non-security-based swap agreements are subject to no provisions of the Securities Laws.

And third, the CFMA created a conundrum for CDSs. Prior to the CFMA, CDSs were generally viewed in the United States as options on securities, typically bonds or groups of bonds. For that reason, investment banks generally booked CDSs in a registered broker-dealer or in foreign broker-dealers pursuant to Rule 15a-6 of the 34 Act to avoid the costly net capital charges associated with swaps. The CFMA was apparently intended to change this because it explicitly references “credit spread[s], credit default swap[s], [and] credit swap[s]” as being within the definition of swaps and thus as not being securities. But as we have seen, options on securities are specifically excluded from the term “swap agreement.” CDSs are the economic equivalent of knock-in (that is, contingent) put options on a debt security (the bond that is the reference obligation). On the face of the CFMA, therefore, there appears to be a conflict as to the regulatory status of CDSs. On the one hand, “credit default swaps” are explicitly defined as swaps;

on the other hand, “options on securities” are explicitly excluded from the definition of swaps.

In 2007, the SEC sought to clarify this situation. While acknowledging that “credit default options [which the SEC was then approving for trading on the Chicago Board Options Exchange] have essentially the same structure as credit default swaps,” the SEC issued the following pronouncement:

Despite the similarities between credit default options and OTC credit default swaps, the Commission wishes to make two things clear. First, because credit default options will be exchange-traded and not individually negotiated (and not necessarily between eligible contract participants), they are not qualifying swap agreements under Section 206A of the Gramm-Leach-Bliley Act (“GLBA”), 15 U.S.C. 78c note, and, therefore, not

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excluded from the definition of security by Section 3A of the Act, 15 U.S.C. 78c-1. Second, certain OTC credit default swaps are not securities. The finding that credit default options are securities because they are options based on the value of a security might suggest that OTC credit default swaps are also options based on the value of a security or securities and, therefore, excluded from the definition of swap agreement because Section 206A(b)(1) of the GLBA, 15 U.S.C. 78c note, excludes from the definition of swap agreement “any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof.” However, Congress specifically enumerated “credit default swaps” (without defining the term) as one example of a qualifying swap agreement. See Section 206A(a)(3) of the GLBA, 15 U.S.C. 78c note. The Commission views the specific enumeration of “credit default swaps” as reflecting the intention of Congress to exclude certain OTC credit default swaps from the definition of security pursuant to Sections 206B & C of the GLBA, 15 U.S.C. 78c note.³⁵

It is certainly possible to disagree with the SEC’s reasoning, but for the time being, it appears settled that CDSs are not securities (at least as far as the SEC is concerned). Nevertheless, even if they are not securities, CDSs are “securities-based swaps” subject to the anti-fraud provisions of the Securities Acts. Thus, after concluding that CDSs are swaps and not securities, the SEC went on to note:

²⁷ GLBA § 206(A)(a)(1), 15 U.S.C. 78c (2008).

²⁸ GLBA § 206(A)(a)(2), 15 U.S.C. 78c (2008).

²⁹ GLBA § 206(A)(a)(2), 15 U.S.C. 78c (2008).

³⁰ GLBA § 206(A)(b)(1), 15 U.S.C. 78c (2008).

³¹ GLBA § 206(B), 15 U.S.C. 78c (2008).

³² GLBA § 206(C), 15 U.S.C. 78c (2008).

³³ GLBA § 206(B), 15 U.S.C. 78c (2008).

³⁴ 33 Act §17(a).

³⁵ 72 Fed. Reg. 32372, 32375-6 (June 12, 2007).

Credit default swaps that involve terms similar to credit default options, but that are otherwise excluded from the definition of security because they are qualifying swap agreements, remain subject to the Commission's antifraud jurisdiction (including authority over insider trading) as "security-based swap agreements"³⁶

On the state regulatory side, the CFMA attempted to bring clarity to a very confused situation. Betting or speculating on price movements in securities or commodities without actually owning the referenced security or commodity has been prohibited by state law since the early 19th Century. The objective of the various states' laws was to ban "bucket shops" that hold themselves out as facilities where customers could buy or sell securities or commodities when, in fact, these bucket shops were simply taking the other side of the customers' "trades" without ever executing the orders. Bucket shops bet against their customers, surviving when they had bets on both

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sides of the market, and "skipping town" when bear or bull markets wiped them out. In 1909, New York's General Business Law § 351 was enacted to prohibit the making or offering of a purchase or sale of a security, commodity, debt, property, options, or bonds without intending a bona fide purchase or sale of the item.³⁷ There was a question prior to 2000, whether trading various OTC derivatives—including CDSs—violated this provision (and the provisions of other state bucket shop and gambling laws like it). The CFMA answered this question by explicitly preempting state and local gaming and bucket shop laws, except for general antifraud provisions, with respect to any "agreement, contract or transaction" excluded or exempt from the CEA.³⁸ Thus, CDSs are not, and cannot be, prohibited by state law in so far as they might run afoul of state bucket shop prohibitions. Nothing, however, is prohibited about state insurance regulation.

³⁶ 72 Fed. Reg. 32372, 32375, n. 39 (June 12, 2007).

³⁷ N.Y. CLS Gen. Bus. § 351.

³⁸ CEA § 12(e)(2), 7 U.S.C. 16(e)(2).

WHAT IS THE ISSUE?

As a result of the CFMA, CDSs and other OTC derivative contracts are not subject to any federal regulation. But with the failure of Bear Stearns, Lehman Brothers, the bond insurance companies, and the injection of massive amounts of government money into American Insurance Group (AIG), it has become apparent that despite several industry reports recommending "reforms,"³⁹ the derivatives industry has made little progress toward assuring the safety and soundness of the CDS market. Establishment of a centralized clearing facility providing for adequate reporting and recordkeeping, and imposing standards to assure the financial stability of credit protection sellers, all seem a long way off.

The "free market's" failure to prevent the CDS meltdown forced many regulatory players to jump into the mix with a variety of proposed regulatory fixes. Interestingly, the NYID was the first, issuing Circular 19 on September 22, 2008. The next day, Chairman Cox of the SEC proposed that the SEC be given regulatory jurisdiction over CDSs.⁴⁰ A CFTC staff report, on October 15, 2008, recommended, among other things, that the CFTC consider the elimination of the bona fide hedge exemptions for swap dealers; the creation of a new, limited risk management exemption; and centralized clearing for CDSs and other OTC derivatives.⁴¹ On November 14, 2008, the President's Working Group

³⁹ See for example, Counterparty Risk Management Policy Group, *Containing Systemic Risk: The Road to Reform, The Report of CRMPG III* (August 6, 2008); Operations Management Group, ISDA, *Letter to Timothy Geithner, President, Federal Reserve Bank of New York* (March 27, 2008).

⁴⁰ "Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, before the Committee on Banking, Housing, and Urban Affairs, 110th Cong." (September 23, 2008) (by Christopher Cox, Chairman, SEC) (available at www.sec.gov/news/testimony/2008/ts092308cc.htm).

⁴¹ Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations, CFTC Release No. 5542-08 (September 11, 2008) (available at www.cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf). See also "Testimony To The United States House Of Representatives Committee On Agriculture Hearing To Review The Role Of Credit Derivatives In The U.S. Economy" (by Walter Lukken, Acting Chairman, CFTC (November 15, 2008)) (available at www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-48.pdf); "Statement of Commissioner Michael V. Dunn on the Memorandum of Understanding Between the Federal Reserve Board, the CFTC, and the SEC Regarding Central Counterparties for Credit Default Swaps" (November 14, 2008) (available at www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/dunnmoustatement111408.pdf). But see "Dissent of Commissioner Bart Chilton on the Memorandum of Understanding Between the Federal Reserve Board, the CFTC, and the SEC Regarding Central Counterparties for Credit Default Swaps" (November 14, 2008) (available at www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/chiltonmoustatement111408.pdf).

on Financial Products (Working Group) recommended “a series of initiatives to strengthen oversight and the infrastructure of the OTC derivatives market.”⁴² These recommendations included (1) development of “credit default swap central counterparties”; (2) articulation of “policy objectives to guide efforts to address the full range of challenges” associated with OTC derivatives; and (3) “issue[ance] of a progress summary to provide an overview of the results.”⁴³ To effectuate the Working Group’s recommendations, its members signed a Memorandum of Understanding “to make the process easier and eliminate regulatory arbitrage.”⁴⁴ Thus, by mid-November 2008, the SEC and CFTC each on their own were proposing new regulatory regimes and the Working Group (which consists of the Treasury Department, FRB, SEC, and CFTC) was proposing yet another regulatory approach.⁴⁵

On November 21, 2008, Congress got into the act when Senator Harkin introduced the Derivatives Trading Integrity Act, which would amend the CEA “to eliminate the distinction between ‘excluded’ and ‘exempt’ commodities” and to provide that “regulated, exchange-traded commodities and futures contracts for all commodities would be treated the same.”⁴⁶ This bill would also eliminate “the statutory exclusion of swap transactions, and end ... the CFTC’s authority to exempt such transactions from the general requirement that a contract for the purchase or sale of a commodity for future delivery can only be traded on a regulated board of trade.”⁴⁷ As a result, under the bill, “all futures contracts” would be traded on a designated contract market or a derivatives transaction execution facility.⁴⁸

⁴² Press Release, “U.S. Department of the Treasury, PWG Announces Initiatives to Strengthen OTC Derivatives Oversight and Infrastructure” (November 14, 2008) (available at www.treas.gov/press/releases/hp1272.htm).

⁴³ “Central Clearing House Poised for Approval,” *Financial Times* (November 18, 2008).

⁴⁴ “Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps” (available at www.treas.gov/press/releases/reports/finalmou.pdf).

⁴⁵ The President’s Working Group on Financial Products, “Progress Update on March Policy Statement on Financial Market Developments” (available at www.ustreas.gov/press/releases/reports/q4progress%20update.pdf).

⁴⁶ The Derivatives Trading Integrity Act of 2008, S. 3714, 110th Cong. (November 20, 2008), introduced by Senator Thomas Harkin and referred to the Senate Committee on Agriculture, Nutrition, and Forestry. See also “Harkin: Control ‘financial weapons of mass destruction,’” *Delta Farm Press Online Exclusive* (November 21, 2008).

⁴⁷ “Harkin: Control Financial Weapons,” above.

⁴⁸ *Id.*

Given the diversity of the various federal proposals for the regulation of CDSs, the necessary delay in achieving consensus with respect to them, and the uncertainty of their enactment, the NYID’s plan to treat CDSs as insurance contracts appears extremely attractive initially. New York’s plan requires no legislative action; it could take effect promptly; it would regulate covered CDSs in an apparently appropriate manner; and it would be administered by an agency with considerable expertise in regulating financial guaranty insurers (FGIs) and little or no responsibility for allowing the current financial crisis to envelop the world’s credit markets. So what is wrong with the NYID proposal? Before answering that question it is necessary to look first more closely at the proposal itself.

CIRCULAR LETTER NO. 19

Circular 19 is captioned “‘Best Practices’ for Financial Guaranty Insurers,” and for the most part it represents a sensible articulation of the practices that FGIs regulated by the NYID should follow. Circular 19 prohibits FGIs, among other things, from (1) insuring pools of asset-backed securities unless certain (quite

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sensible) conditions are met; (2) insuring the obligations of CDS protection sellers unless the “insurers” risks are roughly comparable to the amount and timing of risks the FGIs would assume if they were directly insuring bonds;⁴⁹ and (3) clarifying the manner in which FGIs should calculate their “single risk limits” to more effectively limit their exposure to any one risk or group of risks. While by no means entirely uncontroversial, if Circular 19 had been limited to an articulation of “best practices” for FGIs, it would not have drawn the attention or criticism it has.

The bombshell in Circular 19 is a single paragraph in the section on “Credit Protection for CDS.” There, the Superintendent notes that a prior opinion issued by the NYID’s Office of General Counsel (OGC), had stated that a CDS is not an insurance contract if the payment by the protection seller is not conditioned on the protection buyer demonstrating an actual

⁴⁹ Circular 19, at 8.

pecuniary loss. But according to the Superintendent, this opinion “did not grapple with whether . . . a CDS is an insurance contract when it is purchased by a party who, at the time at which the agreement is entered into, holds, or reasonably expects to hold, a ‘material interest’ in the referenced obligation.” The Superintendent then announced that this omission would be rectified and addressed in a forthcoming OGC opinion.⁵⁰ To eliminate any doubt as to what this opinion would conclude, the Governor’s Press Release accompanying Circular 19 made clear that the opinion would state that covered CDSs are insurance contracts.⁵¹

Thus, as contemplated by Circular 19, CDS protection sellers to those buyers of protection that hold material interests in the referenced obligations (covered CDSs) are selling “insurance contracts.” Accordingly, such protection sellers must be licensed

Over the past year, the CDS market has hardly operated as anticipated by market participants, much less as anticipated by the FRB, SEC, and CFTC.

as FGIs by New York; their financial and other practices must comply with all regulations applicable to FGIs; and their salespeople must be licensed as insurance salespeople.⁵² To appreciate just how revolutionary—and astonishing—this NYID proposal is, some background is useful.

Article 69 of the New York Insurance Law (Article 69) was adopted in 1989 to assure the financial

solvency of FGIs by imposing on them minimum capital requirements, contingency reserves, aggregate risk limitations, single-risk limitations, and limitations on policies written on non-investment grade securities. Under Article 69 “financial guaranty insurance” is defined as a surety bond; an insurance policy; an indemnity contract; and any guaranty similar to the foregoing, under which a payment is due to an insured upon “proof of occurrence of financial loss.” This definition is generally consistent with New York’s general definition of “insurance” as an agreement under which an insurance company is obligated to confer a pecuniary benefit upon another party (the insured or beneficiary) dependent upon “the happening of a fortuitous event” that will adversely affect an asset in which the “insured . . . has . . . [a] material interest.”⁵³

Prior to the issuance of Circular 19, the NYID interpreted both Article 69 and other parts of the New York Insurance Law so as to avoid treating derivatives as insurance contracts.⁵⁴ The NYID position was that CDSs were not insurance because the “triggering event” to payment was not dependent on the protection buyer suffering a loss. For example, in 2000 the OGC of the NYID issued an opinion (2000 CDS Opinion)⁵⁵ specifically addressing a CDS under which the protection seller was obligated to pay the protection buyer upon the occurrence of a negative credit event. The NYID determined that such a CDS was

⁵³ NY CLS Ins. § 1101(a) (2008). Key to this definition is the assumption that the insured will be adversely affected by the specified fortuitous event. In other words, insurance requires establishment of an actual loss.

⁵⁴ See NYID, Office of General Counsel Opinion (February 15, 2000), determining that weather derivatives do not constitute insurance under the New York Insurance Code; NYID, Office of General Counsel Opinion, deciding that guaranteed investment contracts were not financial guaranty agreements (September 24, 1997); NYID, Office of General Counsel Opinion, “lease bonds” as financial guaranty insurance (May 4, 2004); NYID, Office of General Counsel Opinion, certain letters of credit do not constitute insurance (January 23, 2003). All of these Opinions are available at www.ins.state.ny.us/regelinx.htm; see also NYID, “Catastrophe Options,” Office of General Counsel Informal Opinion (June 25, 1998) (on file with author); letter from Michael J. Moriarty, Asst. Chief Examiner, Property Bureau, New York State Insurance Department, to Bertil Lundqvist, Esq., Skadden, Slate, Meagher & Flom, re: Index Swap Transaction (June 26, 1998) (on file with author). For an index swap transaction to constitute an insurance contract, it must obligate the “index payer (as insurer) to indemnify the fixed rate payment payer (as insured) for actual losses incurred by the fixed rate payment payer Absent such a contractual provision the instrument is not an insurance contract.”

⁵⁵ NYID, “Office of General Counsel Opinion Re: Credit Insurance Policy Issued to Financial Institution,” addressing a credit default option faculty (June 16, 2000) (available at www.ins.state.ny.us/regelinx.htm).

⁵⁰ *Id.*, at 7.

⁵¹ Governor’s Press Release.

⁵² A derivative found to be an insurance policy can only be sold by licensed insurance producers, while protection sellers must be licensed under the relevant financial guaranty insurance laws as insurance companies. In New York, insurance law violations are misdemeanors, N.Y. CLS Ins. § 109(a) (2008), with fines increasing for subsequent violations, N.Y. Ins. Law § 1102(a) (2008). In California, the marketing and solicitation of sales of insurance would be a misdemeanor. Cal. Ins. Code § 1633 (2008). In Connecticut, fines, imprisonment, or both can be imposed for acting “as an insurance producer” without a license. Conn. Gen. Stat. § 38a-704 (2008). (The penalty for acting as an insurance producer without a license is a fine of not more than \$500 or imprisonment of not more than three months or both. *Id.* An “insurance producer” is defined at Conn. Gen. Stat. § 38a-702(1) (2008).) Under Delaware law, a Delaware corporation can lose its “charter” to do business, 18 Del. Code Ann. § 505(c) (2008), if it acts “as an insurer” without a “certificate of authority,” 18 Del. Code Ann. § 505(a) (2008), to conduct an insurance business. 18 Del. Code Ann. § 505(b) (2008). And in Illinois, no one can “sell, solicit, or negotiate insurance” unless licensed under Illinois insurance laws. 215 Ill. Comp. Stat. Ann 5/500-15(a) (2008).

not an insurance contract because the “seller” must pay the “buyer” upon the occurrence of the negative credit event, without regard for whether the buyer “suffered a loss.”⁵⁶

In 2004, the New York Legislature stepped into the CDS versus insurance controversy. Article 69 was amended to permit FGIs to insure CDSs and CDSs that reference a pool of obligations on other CDSs. In doing so, the following definition of “credit default swap” was added to Article 69:

[A]n agreement referencing the credit derivative definitions published from time to time by the International Swaps and Derivatives Association, Inc. or otherwise acceptable to the Superintendent, pursuant to which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event in respect of, an issuer of a specified security or other obligation; provided that such agreement does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business.⁵⁷

This 2004 amendment to Article 69 was generally understood to constitute a confirmation of the 2000 CDS Opinion. In hindsight, however, and in light of Circular 19, it was no such thing. The new definition was no more than a tautology; CDSs are not insurance contracts unless they are insurance contracts. But despite the ambiguity as to the state of CDSs, prior to the issuance of Circular 19, the NYID never so much as hinted at a reading of the 2004 amendments to Article 69 or that the 2000 CDS Opinion might mean that a CDS involving a CDS protection buyer with “a ‘material interest’ in the referenced obligation” was an insurance contract.⁵⁸ The fundamental question raised by Circular 19 is whether New York’s new approach is sensible or appropriate.

INSURANCE VERSUS CREDIT DERIVATIVES

Over the past year, the CDS market has hardly operated as anticipated by market participants, much less as anticipated by the FRB, SEC, and CFTC. The unprecedented failures (Bear Stearns, Lehman Brothers, and AIG) and the general credit market collapse make it difficult to argue against the assertion that the CDS market should not be allowed to continue

to operate without significant new regulatory controls and disclosure requirements. The NYID is undisputedly in a position to bring some (but not total, by any means) order to the CDS market. So why is the NYID’s proposal to treat covered CDSs as insurance not only a bad idea but one that may be fundamentally destructive of the ultimate objective of a sound, consistent, and effective regulatory structure for the CDS market as a whole? The starting place for understanding the answer to that question is the legal and historical distinctions between insurance and credit derivatives.

In 2000, the National Association of Insurance Commissioners (NAIC), a group composed of the insurance commissioners of the 50 states, the District of Columbia, and four U.S. territories, formed a Definition of Insurance Working Group. That same year, the Working Group issued a “Definition of Insurance”

In a CDS, covered or uncovered, neither party need be at any “risk” whatsoever.

draft working paper (Draft Definition of Insurance), designed to provide “guidance to state insurance regulators on the commonly recognized elements of an insurance product.”⁵⁹ Rather than “detailing a specific list of products which constitute insurance,” the Draft Definition of Insurance addresses the “underlying elements of insurance.” The stated objective is to “allow state insurance regulators the flexibility to apply regulatory practices in an ever changing insurance product environment.”⁶⁰

After summarizing the definition of insurance in eight states, the Draft Definition of Insurance identifies four common terms and concepts: (1) insurance is a contract; (2) the insured promises to pay premiums to the insurance company; (3) the insurance company promises to indemnify the insured in case of a loss; and (4) there is a risk, the threatened loss that will

⁵⁶ Id.

⁵⁷ N.Y. CLS Ins. §§ 6901(j) through (l) (2005); 2004 N.Y. Sess. Laws Ch. 605 (S. 6679-A) (approved and effective October 19, 2004).

⁵⁸ Circular 19, at 7.

⁵⁹ National Association of Insurance Commissioners, Definition of Insurance Working Group, Definition of Insurance draft working paper, at 1 (September 12, 2000) (available at www.naic.org/store_pub_whitepapers.htm#definition_insurance).

⁶⁰ Id., at 2. The NAIC’s mission “is to assist state insurance regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members: protect the public interest; promote competitive markets; facilitate the fair and equitable treatment of insurance consumers; promote reliability, solvency and financial solidity of insurance institutions; and support and improve state regulation of insurance.” NAIC Mission, Statement (available at www.naic.org/index_about.htm; last visited November 19, 2008).

trigger the insurance company's indemnification obligation as specified in the contract. The Draft Definition of Insurance recognizes that risk can be characterized in a number of different ways, including "contingent event, determinable risk contingencies, ascertainable risk contingencies, or hazard or peril risk."⁶¹ But it emphasized that the concept of risk, the threat of a loss by the insured of something of value, is "the central theme of the insurance contract. It is the element which distinguishes insurance from most other contractual relationships."⁶²

In keeping with the Draft Definition of Insurance, the leading insurance treatise *Appelman on Insurance* (Appelman), defines "insurance" as: "A contract by which one party (the insurer), for a consideration

The consequences of shifting covered CDSs from derivative contracts to insurance contracts would be the elimination of precisely those aspects of the CDS market about which there have been no complaints.

that is usually paid in money ... promises to make a certain payment, usually of money, upon the destruction or injury of 'something' in which the other party (the insured) has an interest⁶³ [The insurer thereby provides] a financial risk transfer service . . . funded by the payment of insurance premiums ... receive[ed] from policyholders."⁶⁴ In evaluating which "financial risk transfer services" are insurance, five characteristics are necessary:

- The insured has an "insurable risk" (such as the risk of a financial loss on the occurrence of a disaster, theft, or credit event) with respect to a "fortuitous event" that is capable of financial estimate.⁶⁵
- The insured "transfers" its "risk of loss" to an insurance company under a contract that provides the insured with "indemnity" against the loss (with the indemnity limited to the insured's actual loss).
- The insured pays a "premium" to the insurance company for assuming the insured's "insurable risk."

⁶¹ Draft Definition of Insurance, n. 59 above, at 4.

⁶² Id.

⁶³ Citation omitted.

⁶⁴ Appelman on Insurance 2d, at § 1.4 (LexisNexis 2006).

⁶⁵ The "insured" must be able to demonstrate that it has both an economic and a legal connection to the asset or subject matter of the risk. Financial Services Authority, "Discussion Paper: Cross-Sector Risk Transfers" (May 2002) at Annex B1.

- The insurance company assumes the risks covered in the insurance contract as part of a larger program for managing loss by holding a large pool of contracts covering similar risks. This pool is often large enough that actual losses are expected to fall within expected statistical benchmarks (referred to as risk distribution or risk spreading).⁶⁶
- Before the insured can collect under the contract, the insured must demonstrate that it has actually suffered a loss from an "insurable risk" as the result of an "insured event."

In Circular 19, the NYID asserts that covered CDSs are insurance contracts because the protection buyer at the time the CDS is executed has, or reasonably expects to have, a material interest in the referenced obligation. But it is hard to make sense of why such a circumstance would result in a covered CDS becoming an insurance contract. In a CDS, covered or otherwise, a payment is due under the contract without "proof of an insured loss"; payment is not limited to the lesser of the insured's actual loss or the notional amount of the contract; and "risk" as it is used in the Draft Definition of Insurance is not the "central theme" of the CDS contract. Indeed, "risk" in this sense has no relevance whatsoever to the CDS contract. In a CDS, covered or uncovered, neither party need be at any "risk" whatsoever.

But there are further conceptual problems with the NYID attempt to characterize covered CDSs as insurance contracts. Under an insurance contract, recovery is limited to an amount sufficient to provide "indemnification." But that is not so with a CDS. If the NYID were successful in treating covered CDSs as insurance contracts, would it then limit the payment under a CDS upon a credit event to the amount of the protection buyer's material interest in the referenced obligation? If it were to do so, it would destroy the entire CDS market. And given the key concept of "insurable interest" in insurance law, why is the relevant time for determining whether a CDS is "covered" the initiation of the contract rather than the occurrence of the credit event? Why is a CDS involving a protection buyer with a "material interest" in the reference obligation on the date the CDS was entered into an "insurance contract" even though such a protection buyer could immediately sell its "material interest"? Why isn't a CDS involving a protection buyer who acquires a material interest

⁶⁶ Because most business relationships involve risks and the assumption of risk, the key here is that an insurance company spreads or distributes the risks among a pool of contracts covering similar risks. See *Amerco*, 96 TC 18 (1991), aff'd 979 F.2d 192 (9th Cir. 1992). See also *Treganowan*, 183 F.2d 288 (2nd Cir. 1950).

in the referenced obligation after the contract is executed (without having reasonably expected to acquire that interest at contract execution) and who holds that interest until the occurrence of a credit event an insurance contract? Such questions could go on and on, but they only point up the obvious. The NYID believed CDSs need to be regulated at the time it issued Circular 19; no one appeared willing to do so; the NYID believes it can provide some of the needed regulation; and the NYID stepped into the breach by making up out of whole cloth its supposed regulatory authority.

WHY NOT REGULATE CDSs AS INSURANCE CONTRACTS?

Accepting that the NYID's intentions in issuing Circular 19 were noble, even if its proposal's conceptual underpinnings are seriously flawed, the question remains: Why not let the NYID proceed as it proposes. Isn't doing something to fix the CDS problems better than doing nothing? The answer to that question is "no." Doing what the NYID proposes to do is worse than doing nothing.

Documentation and Bankruptcy. Derivatives are negotiated contracts documented typically with a standard form ISDA⁶⁷ Master Agreement, a customized schedule, and a confirmation for each trade subject to the Master Agreement.⁶⁸ The parties choose the law to which the contract is subject, typically New York or English law. If appropriate, the parties also enter into a Credit Support Annex, which specifies how, when, and by whom collateral is to be posted. These documents are completely customizable—there is no legal requirement that they contain any specified provisions—and they are interpreted as constituting a single "master agreement."

Derivatives documented as a "Swap Agreement" (consisting of a master agreement, schedule, credit support documents (if any) and all associated trade confirmations) are afforded unique treatment under

the U.S. Bankruptcy Code. In 1990 and 1995, the Congress amended the Bankruptcy Code⁶⁹ to assure that OTC derivative contracts would not be tied up in liquidation proceedings. As the Ninth Circuit Court of Appeals noted in 2002, in a case addressing interest rate swaps:

Several provisions in the Bankruptcy Code reflect a strong Congressional policy of protecting interest rate swaps, termination damages and the swap market from the effects of bankruptcy . . . The legislative history of the Swap Amendments⁷⁰ plainly reveals that Congress recognized the growing importance of interest rate swaps and sought to immunize the swap market from the legal risks of bankruptcy.⁷¹

Derivatives generally, and CDSs specifically, are "immuniz[ed] ... from the legal risks of bankruptcy" only if they are documented with a Master Agreement. As long as they are so documented, protection buyers and sellers enjoy a number of key rights. First, the nonbankrupt party has the right to set off any mutual

Treating covered CDSs as insurance contracts would open up the prospect not just of regulatory inconsistencies between covered CDSs and non-covered CDSs but among covered CDS themselves that are subject to the rules of different states.

claims and obligations with respect to the CDS.⁷² Second, the nonbankrupt party has the right to apply any cash, securities, or other property pledged by the debtor to satisfy amounts due from the debtor.⁷³ Third, if it has received any payments from the debtor before insolvency, the nonbankrupt party has the right to keep such payments absent circumstances of actual fraudulent intent.⁷⁴ Fourth, the nonbankrupt party has the right to exercise its contractual right to cause the liquidation, termination, or acceleration of

⁶⁷ ISDA is an international association with more than 860 members in more than 57 countries. "About ISDA" (available at www.isda.org/index.html; last visited December 1, 2008). ISDA has been instrumental in standardizing derivatives transactions.

⁶⁸ ISDA Master Agreements are typically used to document derivative transactions, including the 1992 Master Agreement (Multicurrency - Cross Border) and the 1992 ISDA Master Agreement (Local Currency - Single Jurisdiction), and the 2002 ISDA Master Agreement, which is increasingly being used. Use of an ISDA Master Agreement is not required, and parties to derivatives contracts can enter into customized (sometimes referred to as "home grown") agreements.

⁶⁹ See 1990 Bankruptcy Amendments, PL 101-311, 104 Stat. 267 (1990); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, PL 109-8, 119 Stat. 23 (2005).

⁷⁰ *Thrifty Oil Co. v. Bank of Am. Nat'l Trust Sav. Ass'n*, 322 F.3d 1039 (9th Cir. 2002).

⁷¹ See 11 U.S.C. 502(b)(2) (providing that, upon an objection to a claim, after notice and hearing, the court "shall allow such claim to the extent that . . . (2) such claim is for unmatured interest."

⁷² 11 U.S.C. 362(b)(6).

⁷³ 11 U.S.C. 548(d)(2)(D). Circular 19, in addition, prohibits posting cash collateral.

⁷⁴ 11 U.S.C. 548.

the CDS.⁷⁵ And Fifth, if the nondebtor party had more than one CDS with the debtor, it has the right to treat all CDSs as a single agreement, preventing a trustee from cherry-picking individual transactions.⁷⁶

In stark contrast to the manner in which derivatives are documented, insurance contracts must conform to extensive statutory and regulatory requirements imposed by the various state insurance authorities. Insurance contracts are, thus, generally standardized and require state filings and often state approval prior to being made available to customers. Insurance contracts typically include an insurance application; an actual insurance policy; definitions; declarations; exclusions; conditions; and schedules, exhibits, or endorsements. Key contract provisions describe the responsibilities of both the insurance company and the insured during the policy term, including the risks intended to be insured; the coverage under the policy; the policy limits; coverage in the event of an insured loss; and the types of risks not covered by the policy. The “best practices” prescribed in Circular 19 are examples of state-specified terms for one type of insur-

A way needs to be found to eliminate or control the moral hazard posed by CDSs.

ance contract. If CDSs were deemed “insurance,” the Master Swap Agreement with its attachments could not be used to document these contracts. A new form contract would be necessary, one that included only those items prescribed by Article 69 of the New York Insurance Law.

Accordingly, to treat covered CDSs as insurance contracts would (1) transform a negotiated, highly flexible and customized product into a highly regulated, inflexible product; (2) change the source of law for resolving disputes and interpreting contracts from established commercial precedent under New York or English law to the insurance laws of whatever state regulates the protection seller; and (3) strip protection buyers of all of the rights in bankruptcy they now enjoy by forcing defaulting protection sellers into state-regulated liquidation proceedings. (Insurance companies are not eligible to be treated as “debtors” under the U.S. bankruptcy laws.)

The consequences of shifting covered CDSs from derivative contracts to insurance contracts would be the elimination of precisely those aspects of the CDS

market about which there have been no complaints. Whatever the problems with CDSs, they are not that CDSs are highly flexible and customizable; that the parties have access to skilled commercial adjudication; or that default does not result in the stay of a counterparty’s rights. In other words, whatever the presumed protections that would result from New York regulation of covered CDSs as insurance contracts, unless those benefits can only be achieved through insurance regulation—which most assuredly is not the case—the move would not only be without justification but seriously hurtful and disruptive.

Taxation. If New York were to treat covered CDSs as insurance contracts, covered CDSs would likely be treated as insurance for U.S. tax purposes as well. This is because one of the key factors in evaluating whether a product is insurance for tax purposes is whether it is regulated as insurance. The tax definition of insurance is not based on any specific statutory or regulatory definition. Rather, it is based on *Helvering v. Le Gierse*,⁷⁷ where the U.S. Supreme Court examined the definition of insurance in the context of a life insurance policy. The Court identified four relevant factors in determining whether a contract is insurance “in its commonly accepted sense” for tax purposes: (1) the form and regulatory treatment of the contract; (2) the existence of an actual insurance risk; (3) the transfer of that risk from the buyer to the party assuming it; and (4) the pooling and distribution of the insurance risk by the party assuming it. These factors have meant that the treatment of a contract as “insurance” for tax purposes turns in large part on its treatment for regulatory purposes.⁷⁸

The current tax treatment of derivative contracts is extraordinarily complicated⁷⁹ but treating CDSs as insurance, instead, would be wrong for at least three key reasons. First, if protection sellers under covered CDSs are deemed to be selling insurance, they would be subject to the U.S. tax rules applicable to insurance companies. To simplify considerably, insurance companies are taxed as corporations,⁸⁰ with premiums received

⁷⁷ 312 U.S. 531, 541 (1941), rev’g 110 F.2d 734 (2d Cir. 1940), 39 B.T.A. 11134 (1939).

⁷⁸ See NYSBA Tax Section Comments on Credit Default Swap Rules, addressing IRS Notice 2004-52, at. 41-45 (September 9, 2005) (available at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1095rpt.pdf). See also David Nirenberg and Richard Hoffman, “Are Credit Default Swaps Insurance?” 3 Derivatives Report, at 7 (December 2001).

⁷⁹ See Andrea S. Kramer, *Financial Products: Taxation, Regulation and Design* (CCH 3d. ed. & Supp. 2008).

⁸⁰ IRC Section 985.

⁷⁵ 11 U.S.C. 556.

⁷⁶ 11 U.S.C. 560.

from customers treated as ordinary income, subject to certain exemptions.⁸¹ Derivatives, on the other hand, are capital assets in the hands of investors and traders and ordinary assets in the hands of dealers and hedgers. Depending on the type of derivative contract, applicable rules apply to the timing of gains and losses.

Second, if protection buyers are entering into insurance contracts, rather than derivatives contracts, when they buy CDSs, they would have an ordinary deduction for those premiums that qualify as ordinary and necessary business expenses.⁸² Otherwise, deductions could be subject to various limitations.⁸³ Proceeds received upon a credit event would not be taxed unless the proceeds exceeded the insured's tax basis in the property "covered" by the insurance, or if the proceeds represent lost business profits. If insurance proceeds cannot be tied to insured property or represent lost business profits, they are taxable at ordinary rates. But how could these rules be administered in the case of covered CDS buyers who need not prove a loss to collect under CDSs? In addition, if the protection seller is a foreign entity, protection buyers might be subject to an excise tax imposed on premiums paid by U.S. companies to a foreign insurance company.⁸⁴ At present, CDSs are treated as derivatives and their gain or loss is capital for investors and traders and ordinary for dealers and hedgers, with timing of gains and losses depending on the type of derivative contract.

Third, so long as CDSs are treated for tax purposes as derivative contracts, protection buyers and sellers that are foreign entities are exempt from U.S. taxation under one of the trading safe harbors. As derivative contracts, parties to CDSs are eligible for both the securities trading safe harbor and the derivatives safe harbor, as long as they are not dealers in CDS contracts. These entities would find themselves outside of the protections of the trading safe harbors if CDSs are treated as insurance contracts.⁸⁵ Insurance activities are not covered by these safe harbors because insurance is neither "trading in stock or securities" nor "effecting transactions in derivatives." Foreign entities could find themselves in a U.S. trade or business if the trading safe harbors do not apply.

⁸¹ IRC Section 501(c)(12).

⁸² IRC Section 162.

⁸³ IRC Section 212, subject to limitations set out in Sections 67 and 68.

⁸⁴ IRC Section 4371. Insurance premiums subject to the I.R.C. § 4371 excise tax are not subject to a withholding tax because these premiums are not "premiums" in the meaning of Sections 871(a)(1)(A), 881(a)(1). See Rev. Rul. 89-91, 1989-2 CB 129.

⁸⁵ See IRC Sections 864(b)(2)(A)(ii) and (b)(2)(B). See also Prop. Reg. 1.864(b)-1 (1998).

There are many more tax implications to treating CDSs as insurance, none of which were contemplated by the NYID in issuing Circular 19.

Inconsistent Treatment of CDSs. The size of the CDS market is not known precisely, but estimates put its notional amount at more than \$35 trillion.⁸⁶ How this market should be regulated is unquestionably controversial.⁸⁷ But what surely should not be controversial is that there is no justification for regulating "part" of the CDS market as insurance and the rest of the market another way. Some of the obvious anomalies such a regulatory structure would create should make this clear. First, assume a protection seller stands ready to trade with counterparties that both have and do not have a "material interest" in a reference obligation. Presumably such a protection seller would be doing business through two companies: an insurance company for the covered CDSs and a non-insurance company for the uncovered CDSs. Both companies are likely to be rated, and it is possible that the two would be rated differently. But what if the insurance company has a higher rating than the other company? Under this circumstance, all things being equal, a prospective protection buyer would prefer to have the insurance company as its counterparty. But if this protection buyer does not have a "material interest" in the referenced obligation it would not be "permitted" to purchase an "insurance contract" from the insurance company. But if the protection buyer first acquired such a "material interest," then entered into the CDS, and shortly thereafter liquidated the material interest, it could accomplish its objective of dealing with the higher rated entity. A regulatory scheme that creates such a perverse incentive makes no sense.

Second, assume a dealer is operating both an insurance company and a non-insurance company and has sold both covered and uncovered CDSs to the same counterparty. If the dealer's non-insurance company defaults on its CDSs and goes into bankruptcy, the counterparty will have a clear right to net all of its uncovered CDSs, assuming they are documented under the same master swap agreement. But the counterparty will not be able to net or close out its covered CDSs because they will have been documented as insurance contracts, which are not eligible for the special bankruptcy

⁸⁶ See ISDA, ISDA Mid-Year 2008 Market Survey Shows Credit Derivatives at \$54.6 Trillion (September 25, 2008) (available at www.isda.org/index.html); follow "Press" hyperlink; then follow "Press Releases (2008)" hyperlink; DTCC Deriv/SERV Trade Information Warehouse Reports (available at www.dtcc.com/products/derivserv/data/index.php).

⁸⁷ See discussions of "What is the Issue?" and Circular Letter No. 19 above.

protections available to swaps. If both the dealer's insurance company and non-insurance company default on their CDSs, the non-insurance company would go into bankruptcy and the insurance company would go into state administered liquidation. The counterparty could net and close out all of its uncovered CDSs, but the covered CDSs could not be netted either against each other or against the uncovered CDSs. Indeed, the counterparty's claims based on the covered CDSs would in all likelihood be stayed either by court order or on jurisdictional grounds, and those claims would be put on hold indefinitely, if not permanently.

Third, New York is the primary regulator for most FGIs, but not all. And, just because New York takes one approach to CDS regulation does not mean that the other states will not come forward with their own, different regulatory approaches to CDSs. To date, a few states have indicated that they are considering treating CDSs as insurance contracts (including New Jersey, Missouri, and South Carolina),⁸⁸ and the NAIC has formed a nine-state Credit Default Swap Working Group for the purpose of recommending "an intended regulatory course of action as to how credit default swaps should be regulated."⁸⁹ Thus, treating covered CDSs as insurance contracts would open up the prospect not just of regulatory inconsistencies between covered CDSs and non-covered CDSs but among covered CDS themselves that are subject to the rules of different states. This, quite literally, would be a mess.

⁸⁸ See Summary of Public Comments and Agency Responses of the New Jersey Department of Banking and Insurance, Office of Solvency Regulation re: Insurance of Municipal Banks, Asset Backed Securities and Consumer Debt Obligations, filed January 24, 2008, as R. 2008 d. 37, in connection with the proposed adoption of N.J.A.C. 11:7-1.1 and 1.5; Jon S. Corzine, Governor, State of New Jersey, Address to the Joint Session of the Legislature (October 16, 2008) (available at www.state.nj.us/governor/news/speeches/economic_plan.html); Raymond J Lehmann, States Could Claim Stake as Credit Default Swap Regulators, BestWire, October 20, 2008, quoting Scott Richardson, Director, South Carolina Department of Insurance: "Personally, I don't think there's any question that covered swaps are insurance We've allowed Wall Street for 20 years to say a cat was really a dog. They will tell you that it is a 'financial instrument,' but what does that really mean? It means that Wall Street doesn't want it regulated." and Linda Bohrer, Acting Director, Missouri Department of Insurance, saying that her Department "has drafted a rule for treating covered CDS as insurance, but thus far has deferred to the National Association of Insurance Commissioners. Leadership at the NAIC has 'indicated a multistate initiative is in the works' for covered CDS."

⁸⁹ NAIC Credit Default Swap (EX) Working Group (www.naic.org/committees_ex_credit_default_swap_wg.htm). On December 7, 2008, Thomas R. Sullivan, Commissioner of Insurance for the State of Connecticut, recommended that given proposed federal action to regulate these products, the working group should continue to monitor developments but take no action at this time. Interview with Thomas R. Sullivan, Commissioner of Insurance for the State of Connecticut, in Grapevine, TX (December 7, 2008).

GOING FORWARD

Circular 19 represented a bold, if misguided, step by New York to seize control of a large piece of the CDS market. On November 20, 2008, Eric Dinallo, Superintendent of the NYID, testified before Congress, and asserted that Circular 19 had "played an important role in spurring national discussion about a comprehensive regulatory structure for the CDS market."⁹⁰ He continued; "[t]he result has been exactly as envisioned—a broad debate and discussion about the best way to bring controls and oversight to this huge and important market and concrete progress toward a centralized risk management, trading, and clearing system." He claimed that it was only after the NYID announced its proposal that "SEC Chairman Cox asked for the power to regulate the credit default swap market. The New York Federal Reserve began a series of meetings with the dealer commodity to discuss how to proceed . . . [and] . . . the President's Working Group . . . announced a memorandum of understanding among the Federal Reserve, the SEC and CFTC to cooperatively implement a central counterparty plan for CDS transactions." More recently, because of Circular 19 "[t]he New York Federal Reserve Bank and New York Banking Department [began] working with one of the proposed central counterparties to establish a New York trust company to serve as a clearing house for credit default swaps."⁹¹

Dinallo identified the key provisions that will need to be included in an effective regulatory scheme for CDSs, and he acknowledged that:

The best route to a healthy market in credit default swaps is not to divide it up among regulators. It would not be effective or efficient for New York to regulate some transactions under the insurance law, while other transactions are either not regulated or regulated under some other law. The best outcome is a holistic solution for the entire credit default swap market.⁹²

As positive as these views are—particularly when coupled with his announcement that "New York will delay indefinitely [its] plan to regulate part of [the CDS] market"⁹³—the Superintendent did not back away from the NYID's claim of jurisdiction over covered CDSs. Indeed, the Superintendent pointedly stated that the NYID is "prepared to consider any necessary changes in state law to prevent problems

⁹⁰ Dinallo Testimony, at 6.

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

that might arise from the fact that some swaps are insurance.”⁹⁴

Surely, further regulation of the CDS market is called for. And, as the regulation is hammered out, the clear moral hazard created by CDSs should be kept clearly in mind. Financial products that provide for payment in the event of loss potentially give the buyer an incentive to bring about that loss. CDSs create such an incentive because payment is triggered when bad things happen. Indeed, the key insurance law concepts of “insurable interest” and “indemnification” exist precisely to prevent an insured having a negative economic interest in the insured “thing.” Insurance that is limited to indemnification of loss with respect to an insurable interest does not pose a moral hazard. A way needs to be found to eliminate

or control the moral hazard posed by CDSs. This is not at all to suggest that the moral hazard associated with CDSs should be dealt with in the same way as the moral hazard associated with insurance. To the contrary, the concepts of indemnification and insurable interest appear quite inappropriate for dealing with moral hazard with respect to CDSs. Furthermore, as the scope and nature of CDS regulation is worked out, a cocked eye should be kept on New York (and other state insurance regulators) to be sure they continue “to work expeditiously” as New York has promised “with all concerned to find a workable solution to the problem of how to regulate credit default swaps”⁹⁵ but does not move forward with its ill-conceived and potentially highly disruptive attempt to regulate covered CDS as insurance contracts. ■

⁹⁴ Id.

⁹⁵ Id.