UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 13 | Issue 1 Article 7

2009

Filling a Regulatory Gap: It is Time to Regulate Over-the-Counter Derivatives

Thomas Lee Hazen

FILLING A REGULATORY GAP: IT IS TIME TO REGULATE OVER-THE-COUNTER DERIVATIVES

THOMAS LEE HAZEN*

The recent credit crisis has highlighted the lack of regulation for credit default swaps that has both magnified and contributed to market failure that began in the latter half of 2008.[1] Securities regulation covers most types of investment contracts, but currently does not include non-securities based derivative contracts such as credit default swaps.[2] The unique aspect of credit default swaps is that unlike other risk shifting contracts such as insurance, they are not regulated. The diverse regulatory schemes for insurance, securities, and commodities futures contracts do not cover over-the-counter credit default swaps. Thus, even though like insurance, left unregulated, credit default swaps run the risk of being nothing more than a form of legalized gambling. This essay examines the regulation of instruments similar to credit default swaps and concludes that credit default swaps should be regulated as well.

A credit default swap (CDS) is a derivative investment that has been the topic of much discussion over the past several months. Unregulated CDSs have been justified as a useful device for dealing with risk. There are many other risk shifting devices

* Cary C. Boshamer Professor of Law at the University of North Carolina at Chapel Hill School of Law. This Article is an expanded version of an article that will appear in the second issue of 34 ADMIN. & REG. L. NEWS 3 (forthcoming winter of 2009). Portions are also adopted from Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. OF BANKING & FIN. L. 375 (2005).

1. For a discussion of the factors contributing to the crisis *see* Eamonn Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5 (2009).

2. *See* Securities Act of 1933 § 2A, 15 U.S.C. § 77b-1(a) (2006) (providing "[t]he definition of 'security' in section 77b(a)(1) of this title does not include any non-security-based swap agreement (as defined in section 206C of the Gramm-Leach-Bliley Act)." Security-based swap agreements are not securities either, but they are subject to the federal securities laws' antifraud provisions. *See id.* at § 77b-1(b); *also* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).

including traditional insurance. Insurance, of course is a regulated activity, with state-based insurance regulation.[3] There currently is increasing sentiment to regulate the CDS market. Securities and Exchange Commission Chairman Cox has called for a centralized regulated CDS clearing system.[4] The President's Working Group on the credit crisis also proposed centralizing the CDS market. New York State announced plans to regulate CDS transactions as insurance but has since decided to delay that action. But why limit the discussion relating to swap regulation to the CDS markets? Unregulated derivatives include over-the-counter foreign currency (Forex) contracts, interest rate swaps, equity swaps, and other highly complex derivatives that may equally warrant some sort of regulation. The discussion below explains why regulation of the over-the-counter derivatives markets is warranted.

Derivative (futures and option) contracts are publicly traded on the various commodities exchanges subject to federal regulation by the Commodities Futures Trading Commission (CFTC).[5] Derivatives based on securities and related financial instruments are publicly traded on the securities exchanges which are regulated by the Securities and Exchange Commission (SEC).

Investing in securities is generally considered to be a productive activity as it allows businesses to raise capital which in turn increases productivity and benefits society. Securities investing offers the hope of wealth building for those who invest. Derivatives and insurance provide an opportunity for risk-shifting as well as investment opportunities (often thought of as speculation).[6] Individuals and businesses who have exposure to

3. *See, e.g.,* ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 51-84 (2d ed. 1996).

4. Subsequently, the SEC agreed to allow LCH Clearnet Ltd. to operate as a central clearing party for credit default swaps. *See* News Release, SEC, SEC Approves Exemptions to Allow Central Counterparty for Credit Default Swaps (Dec. 23, 2008), *available at* 2008 WL 5342187.

5. *See* Commodity Exchange Act, 7 U.S.C. §§ 1 *et seq.* (2006). In December 2008, the Chicago Mercantile Exchange applied to the CFTC to be recognized as a centralized clearing entity for credit default swaps. *See* News Release, CFTC, CFTC Announces that CME has Certified a Proposal to Clear Credit Default Swaps (Dec. 23, 2008), *available at* 2008 WL 5342186.

6. *See, e.g.,* Philip McBride Johnson, *Stepping it Up*, FOW DERIVATIVES INTELLIGENCE FOR THE RISK PROF'L, Issue 336 (Nov. 2001) (stating "[d]erivatives have always been a type of insurance. They differ from the classical model only in that, instead of assembling a 'risk pool' funded by a large number of at-risk holders,

risk can either hedge against that risk with a derivatives contract or seek insurance against losses that could occur if the contingencies created by the risk materialize.[7]

In contrast to investing, hedging, and insurance, gambling is not generally viewed as a productive activity or one that provides a benefit to society.[8] The only benefit attributed to gambling is the entertainment it provides. Long ago, all forms of gambling were outlawed, primarily for moral reasons. Over time, gambling regulation was eased significantly as additional forms of legalized gambling were recognized. Current law takes the view that when properly regulated, gambling's entertainment value can outweigh the social costs and moral objections to wagers and other gambling activities, but gambling is only permitted under strict regulation.[9] Many gambling contracts remain illegal.[10]

---

the risk is passed on to people who would not otherwise face it. The world's most legendary speculators are the 'Names' of Lloyd's of London").

7. Hedging operates as a form of insurance. As explained long ago by one court:

> Hedging affords such protection; it is in the nature of price insurance. The real difference between hedging and gambling is that the hedger has a legitimate interest to protect apart from the hedging transactions, while the gambler has no interest except in the transactions depending on the rise and fall of the market. An insurance contract becomes a wager when the insured has no legitimate interest to be protected against the happening of the event insured against.

Boillin-Harrison Co. v. Lewis & Co., 182 Tenn. 342, 359, 187 S.W.2d 17, 24 (1945) (citing Edwin W. Patterson, *Hedging and Wagering on Produce Exchanges*, 40 YALE L. J. 843-884 (1931)) (providing an interesting discussion of the practice of hedging).

8. *See, e.g.*, IAN AYERS, EDWARD J. MURPHY, RICHARD E. SPEIDEL, STUDIES IN CONTRACT LAW 612 (6th ed. 2003) (stating "[i]t is . . . not always easy to distinguish illegal wagering contracts from other 'aleatory' contracts that have a legitimate commercial or other purpose and are not considered contrary to public policy. Likewise insurance contracts can often be characterized as wagers (and vice versa)").

9. *See, e.g.*, 31 C.F.R. § 132 (forthcoming 2009), implementing the Unlawful Internet Gambling Enforcement Act of 2006, 31 U.S.C.A. §§ 5361 *et seq.* (2009) which prohibits the transmission of funds to gaming sites, regardless of where the gaming sites are located.

10. *See, e.g.* David B. McGinty, *The Near-Regulation of Online Sports Wagering by United States v. Cohen*, 7 GAMING L. REV. 205 (2003) (demonstrating that every state except Utah and Hawaii have some form of legalized gambling); Cory Aronovitz, *The Regulation of Commercial Gaming*, 5 CHAP. L. REV. 181 (2002) (discussing legalized gambling); Paul D. Delva, Comment, *The Promises and Perils of Legalized Gambling for Local Governments: Who Decides How to Stack the Deck?*, 68 TEMP. L. REV. 847, 847-49 (1995) (discussing increased legalization); *see also, e.g.*,

The earliest permissible derivative contracts in the United States were commodity futures contracts traded on public commodity exchanges. The parallel between illegal gambling and permissible derivatives is demonstrated by the following example. Consider two inveterate gamblers who make a wager on whether it will rain the next day. This contract would be considered an illegal wager under the law of most states. Compare this gamble with a farmer who is concerned about a predicted drought and wants to hedge against loss of crops by entering into a derivatives contract based on corn.[11] This is legal as a forward or futures contract and will be enforced. Alternatively, the farmer could make the hedge specifically against damage due to drought and enter into a derivatives contract based on the weather. This more closely resembles the illegal weather wager, but would be a legitimate and hence enforceable derivatives contract. That same farmer has the alternative of seeking crop insurance or drought insurance. In all of the above situations one party (the farmer) is allocating to the other (the counterparty) the risk of a drought. The rain wager is illegal but the futures, forward, and derivatives contracts, as well as insurance, are legitimate commercial transactions.

A similar point could be made with respect to sports wagers which are not permitted except to a limited extent through some

---

RICHARD MCGOWAN, STATE LOTTERIES AND LEGALIZED GAMBLING, 3-21 (1994) (examining the legalization of gambling); R. Randall Bridwell & Frank L. Quinn, *From Mad Joy to Misfortune: The Merger of Law and Politics in the World of Gambling*, 72 MISS. L.J. 565 (2002) (discussing the consequences of increased legalized gambling); John Warren Kindt & John K. Palchak, *Legalized Gambling's Destabilization of U.S. Financial Institutions, and the Banking Industry: Issues in Bankruptcy, Credit, and Social Norm Production*, 9 EMORY BANKR. DEV. J. 21 (2002) (discussing the societal costs of legalized gambling and bankruptcies); Kathryn R.L. Rand, *There Are no Pequots on the Plains: Assessing the Success of Indian Gaming*, 5 CHAP. L. REV. 47 (2002) (evaluating legalized casino gambling on Indian reservations); Wendy J. Johnson, *Tribal Gaming Expansion in Oregon*, 37 WILLAMETTE L. REV. 399 (2001) (discussing gambling in Oregon); A. Gregory Gibbs, Note, *Anchorage: Gaming Capital of the Pacific Rim*, 17 ALASKA L. REV. 343 (2000) (discussing gambling in Alaska); John W. Kindt, *Increased Crime and Legalized Gambling Operations: The Impact on the Socio-Economics of Business and Government*, 30 CRIM. L. BULL. 538 (1994) (discussing the impact of decriminalization of gambling).

11. *See, e.g.*, Scott Marc Kolbrenner, *Derivatives Design and Taxation*, 15 VA. TAX REV. 211, 217 (1995) (stating "[l]ike someone seeking catastrophic health insurance, for example, a hedger is thought of as a risk-averse party seeking to pass on an amount of risk to a risk-neutral (or less risk-averse) party, such as an insurance company, better able to bear it").

state sanctioned casinos. Consider, a hotel owner in New York located near Yankee Stadium who wanted to hedge against the possibility that the New York Yankees will not qualify for the division playoffs, knowing that a divisional playoff in New York would have allowed him to charge premium rates. Should the hotel owner be able to enter into a commercial hedging transaction? Furthermore, even under those limited circumstances where sports wagers may be legal, participants in the sport are not able to wager even though such a wager could arguably be defended as hedging against the financial loss that would result from losing the sporting event. The similarity to gambling is no less when thinking about synthetic collateralized debt obligations (CDOs) or CDSs where the counterparties have no direct exposure to the underlying risks.

One answer to the charge that many derivatives are nothing more than legalized gambling is that they provide legitimate hedging opportunities for investors and, more importantly, for commercial participants in the underlying commodities markets. It is also often pointed out that speculators help make markets more efficient by providing additional liquidity which in turn performs a price discovery function. Hedging operates much like insurance as it allows a risk averse party to pass the risk on to someone else who is willing to bear the risk for a premium. That premium can take the form of an insurance premium or the cost of an options, futures, or swap contract.

With respect to traditional insurance, the risk is absorbed by the insurance company which pools its premiums and manages that pool as an investment to cover claims as they are made by policy holders. It is conceivable in the derivatives markets that both parties to a bilateral derivatives contract will be two hedgers who are able to allocate reciprocal risks to one another. It is also common, however, for risk averse parties seeking a derivatives contract to look to speculators to lay off their risk. For example, a commercial participant may not be able to locate a counterparty to a desired hedging contract if that counterparty must itself be a commercial hedger. Speculators may be characterized as those who accept risk that hedgers do not want. As such, speculators can perform an important function for commercial participants

hedging business risks. By permitting these hedging contracts, the opportunity for speculators is a form of legalized gambling that is not otherwise permitted under gambling regulations. Thus, the same type of risk shifting can be accomplished through insurance, derivatives transactions, and simple wagers.

Publicly traded derivatives contracts are regulated by the CFTC and in some instances by the SEC.[12] Securities transactions, insurance, and gambling are subject to extensive regulation.[13] Until the 1980s, derivative contracts could only be traded in the regulated commodities markets. The expansion of the exclusion of "forward" contracts from futures contract regulation led to emerging over-the-counter derivatives markets for certain large investors engaged in bona fide hedging transactions. This market expanded in the 1990s, with the CFTC taking more of a *laissez-faire* approach notwithstanding the problems that befell some derivatives investors such as the Bank of New York, Procter and Gamble, and Orange County California.[14] These unregulated derivatives markets were given formal approval in the Commodity Futures Modernization Act of 2000.[15] The ill-advised rationale for the absence of regulation was that the market would act as its own regulator. This *laissez-faire* approach has since been recognized as a mistake by one of its strongest supporters, former Federal Reserve Chair Alan Greenspan.

The contract market monopoly for futures contracts eroded due to increased use of forward contracts and swap transactions that were pigeon-holed into existing exemptions from CFTC regulation. The Commodity Exchange Act granted the CFTC exclusive jurisdiction over derivatives, thus precluding SEC

12. *See generally* 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION § 1.04 (2004).

13. *See generally* Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. OF BANKING & FIN. L. 375 (2005).

14. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1278 (S.D. Ohio 1996) (explaining that interest rate swaps lacked commonality and thus were not investment contracts); *see also, e.g.*, Lehman Bros. Commercial Corp. v. Minmetals Int'l Non–Ferrous Metals Trading Co., 179 F. Supp. 2d 159, 165 (S.D. N.Y. 2001) (finding that a foreign currency swap was not a security under N.Y.'s Martin Act).

15. Pub. Law No. 106-554, § 1(a)(5), 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1 *et seq.* (2006)).

regulation of the derivatives markets.[16] In the 1990s, the CFTC's exclusive jurisdiction eased due to continued jurisdictional battles between the CFTC and the SEC with respect to investments that could be characterized either as futures contracts or as securities. The Modernization Act eliminated the former monopoly by permitting over-the-counter and essentially unregulated transactions between qualified market participants.

Commodities law formerly imposed a gate-keeping requirement on the types of permissible derivatives contracts that served a similar function to the insurable interest requirement for insurance policies.[17] Until the adoption of the amendments to the Commodity Exchange Act that were brought in by the Modernization Act of 2000,[18] the CFTC and the various commodity contract markets had to approve each contract that was traded.[19] One of the purposes of this approval process was to assure the economic integrity of each contract. This contract approval process functioned in much the same way as insurance regulation. The Act also changed the designation process so that the CFTC no longer had responsibility for reviewing the economics underlying publicly traded derivatives. Preapproval of the terms of insurance contracts parallels the CFTC's former role in approving futures contracts before they could be publicly traded. To the extent that insurance resembles the derivative investment markets, then it seems appropriate to have parallel regulatory schemes.

To the extent it had jurisdiction, the SEC followed the

16. *See generally* JOHNSON & HAZEN, *supra* note 12, at § 1.04.

17. *See, e.g.,* Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, 100 COLUM. L. REV. 1096, 1099-1100 (2000) (stating "[e]arly insurance schemes were relatively straightforward forms of gambling, with people insuring against the death of public figures with whom they had no personal relationship"); *see also, e.g.,* GRAYDON S. STARING, LAW OF REINSURANCE § 6:1 (1993) (citing 1 SIR M. MUSTILL & J. GILMAN, ARNOULD ON THE LAW OF MARINE INSURANCE AND AVERAGE §§ 331-410 (16th ed. 1981)); Michael J. Henke, *Corporate-Owned Life Insurance Meets the Texas Insurable Interest Requirement: A Train Wreck in Progress*, 55 BAYLOR L. REV. 51 (2003) (discussing the Texas "insurable interest" doctrine in conjunction with corporate-owned life insurance policies, which many employers take out on employees).

18. Pub. Law No. 106-554, § 1(a)(5), 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1 *et seq.* (2006)).

19. *See generally* JOHNSON & HAZEN, *supra* note 12, at § 1.04.

CFTC's lead in taking a hands-off approach to the over-the-counter derivatives markets.[20] Some sort of regulation now seems inevitable but which regulator should fill the regulatory gap?

In making the distinction between insurance and derivatives contracts used to hedge risks, we should not lose sight of the moral hazard concern that leads to the insurable interest requirement imposed by insurance regulation. Nor should we lose sight of the similarity to gambling. Gambles and wagers are not the only examples of contracts that have been outlawed because of their perceived moral repugnancy. In 2003, the Pentagon devised a short-lived plan to create a futures market to allow a hedging against future terrorist attacks.[21] The proposal was quickly quashed.[22] What was it about the proposed terrorism futures that the public found so horrific? Some observers suggested that a market for terrorism futures would allow people to profit from sharing information about future attacks that they should share simply as a matter of good citizenship.[23] There is also the visceral reaction that an investor should not be able to profit from someone else's misery. We, however, generally do not look at an investor's motives in determining whether a particular transaction

---

20. *See generally* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION §§ 1.5, 1.7 (6th ed. forthcoming 2009) (discussing SEC and CFTC jurisdiction over derivatives contracts).

21. *See, e.g.,* Daniel Kadlec, *Terrorism Futures: Good Concept, Bad P.R.*, TIME MAGAZINE, Aug. 4, 2003, *available at* http://www.time.com/time/magazine/article/0,9171,1101030811-472877,00.html. The idea behind the proposal was that since markets help filter information, a market in terrorism futures could provide the Pentagon with help in predicting and then thwarting attacks. *See* Jeff Brown, *Was Terrorist Futures Market Really Such a Terrible Scheme?*, THE PHILADELPHIA INQUIRER, July 31, 2003, at C01; Justin Wolfers & Eric Zitzewitz, *The Furor Over 'Terrorism Futures,'* THE WASHINGTON POST, July 31, 2003, at A19.

22. For example, the originator of the controversial idea resigned his research post with the Defense Department in the face of the huge public opposition to terrorism futures even as a hypothetical model. *See* David Voss, *From Sputnik to . . . Radar? Much-Maligned Defense Research Agency Has Long Been the Pentagon's Fantasy Shop*, BOSTON GLOBE, Aug. 12, 2003, at D1.

23. *See, e.g.,* D. J. Tice, *"Terror Market" Debate Exposed Roots of Many Economic Disagreements*, ST. PAUL PIONEER PRESS, Aug. 6, 2003, at A10. (stating "a terrorism market would inspire people to do out of a selfish desire for gain what they should have done out of moral decency – to tell what they know. And of course that's just the problem. The motives of terrorism 'investors' would be simply too barbarous to be tolerated, and too repulsive to be used, even for the best of purposes. No result, however, beneficial, is worth the moral debasement in rewarding such motives – or at least that's what the politicians quickly decided").

is legal. When put in perspective, how different is a terrorism futures contract from taking out insurance against acts of war? An investor who stands to gain from a terror attack may simply be hedging against losses that would result from such an attack. Investors have always been able to take investment positions in order to "bet" in favor of disaster. There are other ways to invest in terror-related disaster. Defense industry stocks and gold have traditionally been among the havens for investors desiring economic protection against the ill-effects of war or terrorism but these investments are made as part of the regulated securities markets if made through securities or publicly traded futures contracts, unless the investor makes direct purchases of gold. Just as betting on terrorism raises moral hazard issues, so should betting on wide-spread credit defaults such as could be done through the CDS market or through synthetic CDOs.

To some extent, any form of market regulation is paternalistic, but that paternalism is justified. One of the longtime premises of securities regulation is that investors need protection not only against those who would take advantage of them, but also against themselves. The wholesale deregulation of the sophisticated derivatives markets has proven to be a failed free market experiment. No doubt some form of regulation will be imposed. In terms of how the regulatory schemes should evolve, one could argue that the CFTC would be the appropriate regulator as these derivatives grew out of what formerly were known as the commodities markets. On the other hand, the intertwining of derivatives with other financial instruments led the SEC to put in its bid to regulate the CDS market. To the extent that the CDS markets derive their justification as a type of insurance, then insurance regulation could be seen as the appropriate fix, permitting only those market participants with an insurable interest and those counterparties subject to regulation as an insurance provider. An insurable interest has long been a requirement of insurance law.[24] It requires an insurable interest in

24. As a line-drawing rule as to which contracts are enforceable, a bright line test is not applicable. The law in this area is quite muddled. *See, e.g.*, STARING, *supra* note 17, at § 6:1 (citing MUSTILL & GILMAN, *supra* note 17, at §§ 331-410) (stating "[i]n limited space we can talk around insurable interest but never talk it through. A standard text confesses that '[i]t is very difficult to give any definition of an insurable

the contingency insured against in order to uphold the insurance contract.[25] This doctrine originated with life insurance.[26] For example, there was the practice of taking out insurance on famous people and then speculating on their demise much in the same way as any gamble.[27] This practice of wagering on celebrity lives raised a public policy issue often expressed in terms of the policy against gambling.[28] The law in essence sets up a presumption that an insurance contract is a wager on the occurrence or nonoccurrence of a particular contingency and that presumption can be rebutted by demonstrating an insurable interest: "proof of circumstances that negative the existence of a wagering intent establishes the existence of an insurable interest."[29] New York's statute is typical

---

interest,' and then discusses it for about [seventy] pages"). Only an overview is presented here.

25. *See* Henke, *supra* note 17, at 54-59.

26. Kreitner, *supra* note 17, at 1116; *see also, e.g.,* American Cas. Co. v. Rose, 340 F.2d 469, 469-72 (10th Cir. 1964) (upholding employer's insurable interest in life of employee); 3 COUCH ON INSURANCE 3D §§ 41:1 & 41:17 (1997); John M. Limbaugh, Note, *Life Insurance as Security for a Debt and the Applicability of the Rule Against Wager Contracts: Estate of Bean v. Hazel*, 64 MO. L. REV. 693 (1999).

27. *See* Lorraine J. Daston, *The Domestication of Risk: Mathematical Probability and Insurance 1650-1830*, 1 THE PROBABILISTIC REVOLUTION 237, 244 (Lorenz Krüger *et al.* eds., 1987) (stating "London underwriters issued policies on the lives of celebrities like Sir Robert Walpole, the success of battles, the succession of Louis XV's mistresses, the outcome of sensational trials, the fate of 800 German immigrants who arrived in 1765 without food and shelter, and in short served as bookmakers for all and sundry bets").

28. *See, e.g.,* George Steven Swan, *The Law and Economics of Company-Owned Life Insurance (COLI): Winn-Dixie Stores, Inc. V. Commissioner of Internal Revenue*, 27 S. ILL. U. L.J. 357, 357 (2003) (stating:

> Economic insights are studied to ascertain the economic function of the insurable interest doctrine. Public policy contrary to gambling, and the public interest in the minimization of moral hazard, each has been proposed as justification of that doctrine. However, each in turn will be seen to lack sufficient economic weight to justify the doctrine. The economic phenomenon of externality seems to be the true rationale for the application of the insurable interest doctrine to [company owned life insurance]);

Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 J. CORP. L. 723, 725-27 (2000); Lynne A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 Duke L.J. 701, 724-728 (1999); *see also, e.g.*, 3 COUCH ON INSURANCE 2D § 24:117 (1984); Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851, 882 (1993).

29. ROGER C. HENDERSON & ROBERT H. JERRY II, INSURANCE LAW CASES AND MATERIALS 25 (2d ed. 1996).

of the modern statement of the insurable interest requirement:

> No contract or policy of insurance on property made or issued in this state, or made or issued upon any property in this state, shall be enforceable except for the benefit of some person having an insurable interest in the property insured. In this article, "insurable interest" shall include any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage.[30]

The insurable interest requirement of a "lawful and substantial economic interest" describes the type of interest that is present when commercial enterprises decide to enter into hedging contracts. But, it is not always easy to distinguish gambling and insurance. For example, the football game creates the risk of one team winning and the other losing. Similarly, the roll of the dice is the act that creates the risk (of a specific number or pips being exposed). These football and dice games can be enjoyed without the wager. The wager simply adds economic consequences for the parties to the wager, much as a derivatives contract on the price of a commodity provides economic consequences for the speculator. The insurable interest doctrine attempts to provide a basis for drawing the line with respect to insurance contracts that the law will tolerate. It is an imperfect measure at best.

The insurable interest requirement is analogous to the economic purpose requirement that formerly applied to derivatives contracts. Prior to the Commodity Futures Modernization Act of 2000,[31] publicly traded derivatives contracts required approval by the CFTC and the various commodity contract markets. One reason for this approval process was to assure the economic integrity of each contract.[32] This contract

30. N.Y. Ins. L. § 3401 (McKinney 2007); *see also, e.g.*, CAL. INS. CODE §§ 280-284 (West 2005).

31. Pub. Law No. 106-554, § 1(a)(5), 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1 *et seq.* (2006)).

32. *See* JOHNSON & HAZEN, *supra* note 12, at § 2.03.

approval process functioned in much the same way as the requirement of insurance regulation that requires state insurance regulators approve insurance policies that are marketed to consumers.[33] Policymakers should consider whether the failure of the CDS markets has signaled a need to revitalize the commodities laws' economic purpose requirement.

Contrary to the deregulatory trend with respect to gambling activities and the non-securities derivatives markets, insurance remains a highly regulated industry. Several justifications have been advanced for regulating insurance.[34] The justifications that are most analogous to the traditional justifications for regulation of the investment markets include the need "to compensate for inadequate information."[35] This rationale for regulating insurance closely parallels the reasons for implementing the disclosure requirements of the federal securities laws. The justification for strong insurance laws and the accompanying substantive regulation of the terms of insurance contracts is paternalism. Paternalism is controversial since it sacrifices freedom of contract for what policy makers deem to be consistent with "the common good."[36] Nevertheless, policy makers have wisely recognized that a paternalistic approach is appropriate when dealing with risk-shifting using insurance products. The justifications for substantive regulation of insurance contracts may

---

33. *See, e.g.*, 1 COUCH ON INSURANCE 3D § 2.8 (1997).

34. *See, e.g.*, JERRY, *supra* note 3, at 51-54; Spencer L. Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471 (1960); *see also* JERRY, *supra* note 3, at 85 (stating:

> Although the larger objectives of insurance regulation are to prevent destructive competition, compensate for inadequate information, relieve unequal bargaining power, and assist consumers incapable of rationally acting in their best interests, the *articulated* objectives of state legislative regulation are essentially fourfold: (1) ensuring that consumers are charged fair and reasonable prices for insurance products; (2) protecting the solvency of insurers; (3) preventing unfair practices and overreaching by insurers; and (4) guaranteeing the availability of coverage to the public).

The first three objectives apply equally to securities and other investment regulation.

35. JERRY, *supra* note 3, at 52.

36. JERRY, *supra* note 3, at 53-54.

be equally applicable to derivatives regulation – whether that be under the umbrella and rubric of securities regulation or what has traditionally been known as commodities regulation. It thus is time to consider reinvigorating the federal commodities laws in addition to strengthening the securities laws as they apply to derivatives.

Over the next several years policy makers need to consider a number of questions, including, for example, whether the CFTC's familiarity with existing derivatives regulation is sufficient to extend it to the CDS and other over-the-counter derivatives markets or whether the SEC is better equipped to fashion suitable regulation. Other suggestions that have been made include merging the CFTC and SEC, establishing the Treasury Department as the overseer of the SEC and CFTC, or the creation of a new Financial Regulatory Authority to regulate both the securities and derivatives markets as is done in the United Kingdom. Yet another question is the extent to which investment market regulation should be more directly tied to banking and other financial institution regulation.

The dividing lines between futures, swaps and other derivatives, securities, insurance, and gambling regulation have been blurred.[37] The overlapping nature of the sophisticated financial markets makes it difficult to identify the most natural regulator. It follows that instead, we should look for the most suitable regulator in terms of expertise and understanding of the complex financial and derivatives markets. One thing is clear: we need to avoid continuation of a regulatory gap simply because market participants can disguise insurance or gambling as a derivatives contract. Policy makers should focus on substance – regulation that is not dependent on the form of the contract but rather is designed to apply across risk-shifting markets.

37. *See generally* JOHNSON & HAZEN, *supra* note 12, at § 1.02.