I. INTRODUCTION

“Now that the entire derivatives marketplace, both futures and swaps, have come under
comprehensive oversight, I think it’s the natural order of things for some realignment to take
place.” — CFTC Chairman Gary Gensler, CFTC Public Roundtable on Futurization of Swaps,
January 31, 2013

Recently, much attention has been paid to a trend known as “futurization”—the recasting
of economic arrangements previously transacted as “swaps” to trade as “futures” as a result of the
new regulation of the swap markets under the Dodd-Frank Act. Proponents of futurization view
it as a desired transition from previously opaque swap markets to more transparent futures
markets. Opponents of futurization view it as regulatory arbitrage and thwarting congressional

1 Of course, regulatory and academic interest in derivatives and their regulation is not new. See, e.g., Frank
Partnoy & David A. Skeel, Jr., The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019 (2007)
(discussing the benefits of, and risks posed by, credit default swaps); Roberta Romano, A Thumbnail Sketch of
Derivative Securities and Their Regulation, 55 Md. L. Rev. 1 (1996) (providing a comprehensive overview of
derivatives and their regulation in the United States); Lynn A. Stout, Why the Law Hates Speculators: Regulation and

In particular, significant attention has recently been paid to the imposition of central clearing requirements, with a number of notable academics disagreeing with regulatory consensus that central clearing will decrease systemic risk. See, e.g., Darrell Duffie & Haoxiang Zhu, Does a Central Clearing Counterparty Reduce Counterparty Risk?, 1 REV. ASSET PRICING STUD. 74, 75 (2011) (“For plausible cases, adding a new [central clearinghouse] dedicated to a class of derivatives such as credit default swaps (CDS) reduces netting efficiency, increases collateral demands, and leads to higher average exposure to counterparty default. We further show that counterparty credit risk in the OTC derivatives market is exacerbated by a multiplicity of CCPs.”); Mark J. Roe, The Dodd-Frank Act’s Maginot Line: Clearinghouse Construction, CALIF. L. REV. (forthcoming 2013) (manuscript at i), available at http://ssrn.com/abstract=2224305 (calling clearinghouse protection a “Maginot line,” and stating that “clearinghouses are weaker bulwarks against financial contagion, financial panic, and systemic risk than is commonly thought” and that “[m]uch like an overconfidence inspired by powerful military fortresses that an invading enemy can side-step, the reigning overconfidence in clearinghouses hurls regulators to be satisfied that they have done much to arrest problems of contagion and systemic risk by building up clearinghouses, when they have not”); Yeshu Yadav, The Problematic Case of Clearinghouses in Complex Markets, 101 GEO. L.J. 387, 444 (2013) (“The establishment of the clearinghouse is designed to fortify the market against the ill effects of financial innovation in the credit-derivative market. It should mutualize risk and make market players share losses. However, this Article argues that the design of this institution is problematic—and this is exacerbated by the fact that the credit-derivative products it trades are complex and tricky.”); Craig Pirrong, The Economics of Clearing in Derivatives Markets: Netting, Asymmetric Information, and the Sharing of Default Risks Through a Central Counterparty (Jan. 8, 2009) (unpublished manuscript) (on file with the University of Houston Library), available at http://ssrn.com/abstract=1340660 (“Unfortunately, the received analysis of the effects of the creation of a CDS clearinghouse has been superficial and incomplete. As a result, this analysis provides very weak support for the view that a [central clearinghouse] will improve efficiency, or reduce the vulnerability of financial markets to systemic contagion.”).


3 See, e.g., Cliff Lewis, Panelist, CFTC Public Roundtable on Futurization of Swaps (Jan. 31, 2013), at 59 [hereinafter CFTC Roundtable] (transcript available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dssubmission/dsSubmission13_013113-trans.pdf) (“I think the way you’ve approached this is spot on. I think you ought to hold a parade and declare victory because I think actually moving much of this to the futures market is going to be a huge improvement in buy-side financial market management, not just from a risk perspective but from an efficiency perspective.”); Bryan Durkin, Panelist, id. at 94–95 (“[T]he
suggestion that moving any type of similar product or economically equivalently similar product or however it’s been categorized today to a less transparent marketplace and trying to tie that to a futures market is just unacceptable to have to listen to that because the futures markets have many, many decades of development, and these decades of development were premised on transparency and openness. The distribution of our products and our markets are real-time. The information associated with that from a market data perspective, from a clearing perspective, is real-time.

4 See, e.g., George Harrington, Panelist, id. at 45–46 (“In summary, we believe the push towards central clearing is very positive for the market, but forced futurization is a negative and can prove extremely costly to the American consumer.”); Lee Olesky, Panelist, id. at 46–47 (“Fundamentally, we are concerned that as currently constructed and contemplated, the regulatory structure and rulemaking for swap futures creates an uneven playing field for market participants that wish to trade swaps and allows economically equivalent products to be traded subject to different system rules.”); Jeffrey Maron, Panelist, id. at 51–52 (“We believe that such overnight futurization, unlike historical market-driven product evolution, has been significantly distorted by regulation. Accordingly, we believe that this market shift[sic] should be carefully monitored by the Commission since it may harm market functioning if market participants are no longer able to find the choice, flexibility, and the liquidity that they require from the swaps markets.”); Chris Ferreri, Panelist, id. at 75 (“Congressional intent for distinct swaps regulatory regime[sic] is thwarted when the name of a product is changed from ‘swap’ to ‘future’ for the sole purpose of moving it from one regulatory framework to another.”).

5 See, e.g., Bart Chilton, Comm’r, CFTC, CFTC Roundtable, supra note 3, at 24 (“I just wanted to make a quick point. You know, we’ve been hearing a lot about this and not all bad that some of these swaps are becoming futures. I mean, you know, swaps were part of the problem, and so it doesn’t bother me that we see some of this futurization, and the question is: does it become excessive?”); Will Rhode, Panelist, id. at 55 (“Swap futures acts[sic] as a wrapper to insulate swap users from some of the more punitive elements of Dodd-Frank reform. On the one hand, they may be viewed as a healthy innovative response by the financial services industry to regulatory change. Given that Congress looked to the futures market as a guide for swaps reform, it could be argued that swap futures are consistent with regulatory intent. In many ways, they appear to be a logical progression. On the other hand, swap futures can be viewed as regulatory avoidance. To borrow from Myron Scholes, one of the reasons we have financial innovation is to get around rules and regulations.”).


7 Total notional amounts outstanding for all exchange-traded futures contracts as of December 2012. Id. at A146.

8 For example, in April 2013, Bloomberg filed a federal lawsuit against the CFTC seeking an injunction against a rule that would set different mandatory clearinghouse margin minimums for futures and swaps. Complaint at 1–2, Bloomberg L.P. v. CFTC, 2013 WL 2458283 (D.D.C. June 7, 2013) (Civ. No. 13–523(BAH)), 2013 WL 1629236. While the lawsuit was subsequently dismissed on standing grounds, further litigation is sure to follow.

Still others view it as inevitable, with no normative judgment necessary. Given the enormous size of the swap and futures markets—estimates place the swap market globally at $633 trillion in notional size and the futures market globally at $24 trillion in notional size—and the central role of swap market reform in the Dodd-Frank post-financial crisis regulatory plan, the stakes in this debate are high.

In this Article, we apply a new analytical treatment to the futurization trend with a view toward assisting the CFTC to better understand this phenomenon. We create a simple economic model to demonstrate that futurization can be explained through a concept we call “regulation through substitution”—the ability of a regulator to encourage market participants to subject themselves to one regulatory regime versus another through the imposition of differential regulatory costs. The substitution effect, whether for individual products or regulatory regimes, is well known and well understood. What differentiates substitution between the futures and swaps regulatory regimes from most substitution cases, however, is that both regimes are the responsibility of one regulator, the CFTC, which can significantly adjust the “price” of each regime through its regulations. Thus, a single regulator controls not only the absolute price of each regulatory regime but also the relative price of the two regimes it oversees.

Our simple model demonstrates that regulation through substitution is a more nuanced regulatory tool than might otherwise be thought. While most commentators have viewed
futurization as a trend affecting the swap markets in a uniform manner, our model shows how different types of regulations are likely to futurize different segments of the swap markets. Specifically, since different regulations can impose different costs on different segments of the market, a particular regulation may encourage the futurization of a certain subset of swaps but not others. We use this insight to predict how the CFTC’s new Dodd-Frank regulations will incentivize the futurization of certain swap products transacted by certain market participants and may even incentivize the reverse—“swapification”—by other market participants. We conclude that many of the CFTC’s regulatory actions are likely to have consequences different from what the CFTC or market participants may expect.

While this Article applies our model to the futurization trend, the insights provided can be useful in other contexts. Specifically, a regulatory agency charged with oversight over two distinct but related regulatory regimes can predict certain consequences of regulation that would otherwise be considered “unintended.” Armed with this predictive tool, regulatory agencies can design regulations to intend what otherwise would be unintended consequences of regulation. That is, a regulator can apply regulation through substitution to affirmatively achieve desired regulatory outcomes, including the development of side-by-side markets with protections tailored for different groups of participants.  

In summary, we seek to introduce the concept of regulation through substitution, using a simple economic model to explain the recent trend of futurization with a view to informing the CFTC’s ongoing rulemaking for the futures and swap regulatory regimes. Other regulators could also use regulation through substitution in other contexts. In Part II, we provide a primer on futures and swaps and their regulatory history. The unique relationship between futures and swaps, both economically and from a regulatory standpoint, is essential for understanding the dual regulatory structure for economically similar (and indeed sometimes identical) futures and swap products that gives rise to the opportunity for futurization. We then introduce the debate over futurization that has taken place over the past several months.

In Part III, we introduce a basic economic model of substitution of financial instruments. We demonstrate how both absolute and relative regulatory costs are captured by and are important to the model. Part IV applies this model to futurization and describes the ways in which the Dodd-Frank Act and the CFTC’s rules are changing both the absolute cost of swap transactions and, importantly for the futurization debate, the relative cost of swap transactions versus futures transactions. This section also discusses our policy recommendation that the CFTC consider futurization effects when conducting cost-benefit analysis.

In Part V, we use the regulation by substitution model to predict the futurization effects on three critical areas of Dodd-Frank Act swap rulemaking currently underway—margin

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9 Such tailored regulation is particularly important given the highly complex and quickly evolving nature of the swap markets. As Roberta Romano observed with respect to regulation of financial markets more generally, “the nub of the regulatory problem derives from the fact that financial firms operate in a dynamic environment in which there are many unknowns and unknowables and state-of-the-art knowledge quickly obsolesces. In such a context, even the most informed regulatory response—which Congress’s reaction in the recent crises was not—will be prone to error and is likely to produce backward-looking regulation that takes aim at yesterday’s perceived problem, rather than tomorrow’s, for regulators necessarily operate under considerable uncertainty and at a lag behind private actors.” Roberta Romano, Regulating in the Dark, in REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION 86, 87 (Cary Coglianese ed., 2012).

10 In particular, our model is one of substitution under unlimited supply. Such a model is appropriate for financial contracts, like futures and swaps, that consist of sets of obligations created by mutual agreement rather than scarce goods with limited supply (in economics speak, a “non-rivalrous good”). The ability of market participants to enter into futures and swap contracts is, of course, constrained by various factors, such as the amount of capital available to collateralize the contracts, credit lines of financial institutions, and the aggregate amount of risk that market participants are willing to bear. For our purposes, however, the effects of these supply constraints in the current swap and futures markets are negligible.
requirements, protection of customer collateral, and public dissemination of swap trading data. This analysis illuminates how futurization should not be viewed as a single regulation with a single corresponding increased regulatory cost, but rather as a series of individual regulations, each of which imposes differential (and sometimes conflicting) cost effects on various market segments. Thus, regulation through substitution in the futurization context can be a quite targeted regulatory tool to achieve desired outcomes, rather than a blunt instrument that affects all market participants equally. Part VI concludes.