Regulate OTC Derivatives By Deregulating Them: Response to Comments

Lynn A. Stout
Cornell Law School, ls483@cornell.edu

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Response

BY LYNN A. STOUT
UCLA School of Law

In my paper, I proposed that we consider “regulating” the over-the-counter (OTC) derivatives market the same way the common law did: by refusing to enforce an OTC derivative contract unless one of the parties to the contract is truly using it for hedging (insurance) rather than for speculation. In their responses, Jean Helwege, Peter Wallison, and Craig Pirrong each object to this idea for a variety of reasons. Their objections, however, can be boiled down to two basic complaints:

- It is impossible as a practical matter to distinguish speculation from hedging.
- Speculation is either not harmful or is an affirmatively beneficial activity, and should thus not be restrained.

HEDGERS VS. SPECULATORS Any lawyer familiar with the basic principles of insurance law will recognize the first objection as groundless. In the insurance industry, both courts and insurance companies have been distinguishing between the use of insurance contracts for hedging and their use for speculation for centuries. One does not have to be a particularly “wise judge” (to use Craig Pirrong’s phrase) to recognize that when someone buys insurance on a home he does not own, the insurance is being used to make a speculative bet rather than to hedge. Similarly, one does not have to be a particularly wise judge to recognize the difference between a “naked” credit default swap and a credit default swap where one of the parties actually owns the underlying bond that might default.

More importantly, the genius of the common law was that it did not really put the burden on judges to distinguish hedging from speculation — it put the burden on the parties themselves. It is not judges but insurance companies that take the lead in investigating their contract counterparties to make sure that someone seeking to buy an insurance contract actually has an “insurable interest.” Similarly, the common law rule puts the burden on OTC derivatives traders to make sure that at least one of the parties to a contract has an “insurable interest” in the underlying. Because both parties want the transaction to take place, they have every reason to cooperate with each other and exchange the information necessary to assure themselves the contract is a legally enforceable hedge.

PROTECTION? The second objection to the common law rule — that there is no reason to disfavor purely speculative trans-