FINANCIAL WEAPONS OF MASS DESTRUCTION: FROM BUCKET SHOPS TO CREDIT DEFAULT SWAPS

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I. INTRODUCTION

When the current financial crisis arose and the market began to collapse, many were scrambling for answers, searching for the cause of such a widespread and catastrophic market failure. At the time, few looked to, or had even heard of, the incredibly unregulated and relatively new financial instrument known as the credit default swap (“CDS”). As the market continued its freefall, people began to follow the fuse created by homeowners living beyond their means, lenders willing to give away money of nearly any amount with little expectation that it would be repaid, and the greed of Wall Street raking in record profits at the expense of a stable and sustainable economy. At the end of this long and complicated fuse lay a hidden bomb, growing exponentially, in the shadow market of CDSs. A market comprised of instruments that Warren Buffett, the CEO of Berkshire Hathaway, now infamously described six years before our economy imploded as “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”1

While CDSs may only be about a decade old, they are linked to a fundamentally similar, equally risky arcane financial instrument, which helped bring down the market in the Panic of 1907, known as the bucket shop.2 Bucket shops became very popular after the Civil War, even rivaling the stock market in size and the amount of money exchanged, until they were outlawed after the Panic. CDSs and bucket shops are linked not only through the fact that they are very similar financial instruments, but also, at one time, they both were regulated under the same laws.3 However, through deregulation, CDSs eventually followed the same path that bucket shops of the past took and brought down our market.

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As it was deregulation of these instruments that condemned us to repeat the past, it is regulation which will lift us to a prosperous and sustainable economic future. Our government has begun to take action and is continuing to devise various plans in hopes of reversing our economic downturn. We can learn from the past—specifically analyzing the bucket shop response and market response to regulation in the aftermath of the Panic of 1907—to better understand how the regulation of CDSs should be handled and the possible effects on the market that these potential regulations will have. The way in which we resolve this economic crisis will echo throughout our history. Thus, steps must be taken to ensure that an economic disaster of this magnitude will not again occur due to a lack of proper oversight and understanding of financial instruments such as CDSs.

This Note seeks to analyze the role that CDSs played in the 2008 United States economic crisis drawing an analogy to the bucket shops that contributed to the collapse of the market in the Panic of 1907, and recommending potential regulations for the CDS market. Part II describes bucket shops, their effects on the economy, how they contributed to the Panic of 1907, and their subsequent regulation. Part III offers the economic fundamentals of CDSs, their development, and their lack of regulation, establishing a connection to the bucket shops of the past. Part IV recounts the recent fall of our economy, outlining the fuse burning towards disaster, and the role that CDSs played in the eventual implosion of our economy. Part V concludes the Note by offering recommended regulations for the CDS market, while presenting the lessons that can be learned from the regulation of bucket shops after the Panic of 1907.

II. BETTING ON WALL STREET IN THE LATE 19TH CENTURY

A. THE RISE OF BUCKET SHOPS

“There is no more dramatic story in all economic history than that of the rise and fall of the bucket shops.”4 While this may have been an exaggeration by economist James E. Boyle, writing in 1920 soon after the fall of bucket shops, these arcane financial instruments had a significant impact on the economic history of the United States and some of their characteristics can be seen in our modern financial instruments to this day.5 The term “bucket shop”—according to speculator and frequent bucket shop patron, John Hill, writing in 1904—originated in London at the mid-century. The bucket shop at this time was a place “where the urban poor gathered to drink dregs of beer which had been collected in buckets from larger saloons.”6 The bucket shops that emerged in the United States did not stray too far from its origins, serving up a different vice to a similar clientele.

4 JAMES BOYLE, SPECULATION AND THE CHICAGO BOARD OF TRADE 89 (1920).
6 Id.
In the years before the Panic of 1907, with the stock market still evolving, small investors wanted to get a piece of the growing American pie. At this time, exchanges such as the New York Stock Exchange required minimum margins of around ten percent and minimum trades of approximately 100 shares; transactions such as these involved hundreds or even thousands of dollars. These financial requirements effectively prevented the common citizen from playing a part in the stock market, allowing only the wealthy to partake in the business of investing and speculating. In order to overcome this financial barrier, an illegitimate financial institution began to emerge, which offered average citizens an affordable opportunity to seemingly play the market as any wealthy investor would.

This “very pernicious element,” as the New York Times described it in 1908 upon its eradication from New York City, was the bucket shop. Bucket shops were essentially a form of gambling, but instead of ponies or parlor games, bucket shops allowed people to place bets on the stock market. They were derivative trading establishments in the most classic sense, as the value of the wages placed were derived from the underlying value of the stocks that the bets were placed upon. A bettor could place a wager on whether a stock would go up or down, without ever having to buy any stock or hold any actual assets, so in effect, “there is no actual transaction.”

Bucket shops in many ways looked just like a legitimate stock or commodities brokerages, with a stock ticker providing the prices of each stock or commodity that a potential customer could bet upon. These prices were then posted on a large board for the customers to see and place orders on, or rather bet on. A patron of a bucket shop could purchase a stock or commodity with one percent of the margin. In some bucket shops, even one-half of one percent was enough to purchase an order. Due to such a low margin, the sum of money exchanging hands was generally between ten to fifty dollars, making these bets more reasonable for a common citizen, or even a pauper with a gambling problem.

Unlike the actual stock market, where brokers and traders could prosper together, and there need not be a winner and a loser, the bucket shop and its patrons were adversaries, for when the bettor won, the bucket shop lost, and vice versa. This zero sum game was created due to the fact that, unlike the stock and commodities markets, which acted as a means through which goods and assets are traded, the bucket shop acted more like a casino. For the bucket shop took all the orders of its patrons and held them or, as it was said at the time, put them “in the bucket.” No assets were

8 No Bucket Shops for New Law to Hit, N.Y. Times, Sept. 2, 1908, at 8.
9 See The Bet That Blew Up, supra note 2.
11 See Hochfelder, supra note 7, at 340.
12 Bucket Shop Sharpness, N.Y. Times, Nov. 3, 1887, at 3.
13 See Hochfelder, supra note 7, at 343.
14 Id. at 344–345.
transferred and the only purpose of the stock market was to provide the numbers for the order board for the patrons to bet on. So, if a customer of a bucket shop had bet that the price of sugar would rise by a dollar and it subsequently did, the bucket shop, like any casino, would payout the winnings to the patron. However, in the event that the price of sugar dropped below the patron’s invested margin, the bucket shop would claim another victim and rake in its winnings.

As the desire of average citizens to dabble in the risky business of betting on stocks in hopes of large winnings grew, bucket shops began to open up all over the United States. The first bucket shop opened up in New York City in 1877, and by early 1878 they had spread to many of the major cities in the Midwest. The popularity of bucket shops soon exploded, and “[b]y the mid-1880s bucket shops had moved into neighborhoods outside financial districts and into smaller cities and the countryside.” At their peak, bucket shops totaled in the hundreds and began to rival the very stock and commodities markets on which they took bets. Bucket shops were allowed to flourish free of regulation, and for the most part, seen as harmless; as the Chicago Board of Trade’s official historian Charles Taylor noted in 1917, “they were not viewed with particular alarm” but regarded as “a sort of democratized Board of Trade, where the common people could speculate.”

The abundance of bucket shops during this time period created a shadow market generating thousands of unregulated and undocumented transactions. Meanwhile, the actual stock and commodities markets were being deprived of business, as bucket shop transactions surrounded these markets, but did not contribute to them in any way. Due to the lack of records provided by the bucket shops, it is impossible to obtain precise figures on just how much business they were doing, but some have been offered. In 1889, the New York Times “estimated that the patrons of the nation’s bucket shops wagered the equivalent of a million shares a day. By way of comparison, the average daily volume on the New York Stock Exchange in June 1888 was roughly 140,000 shares.” “By way of comparison, the average daily volume on the New York Stock Exchange in June 1888 was roughly 140,000 . . . .” The once small, seemingly harmless betting parlors had overtaken the market, and no longer was it merely the common citizen turning to the bucket shop to place orders on the stock market, but the seasoned investor looking to take advantage of the low margin required to place an order.

B. THE BUCKET SHOP EVILS EMERGE

As the influence and power of bucket shops grew, many began to view them as a danger to the economy, particularly to the stock and commodities

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15 Id. at 340.
16 Id. at 341.
17 Id. at 340.
18 Id. at 345.
19 Id.
20 See id. at 340, 342.
markets that they rivaled. As an 1897 editorial in the *International Herald Tribune* described:

The result of the *Herald*’s investigations of the bucket shops was very curious. Like the jarring of a spider’s web, when one part was touched the whole fabric began to rock, and tremendous commotion ensued among bankers and brokers and men with infallible systems for winning other people’s money by speculating in grain or stocks. A great many of these human spiders were evidently working in concert and spinning a gigantic web to entrap foolish flies from all over the country.\(^\text{21}\)

Bucket shops were coming to be viewed as the evil in the market—the symbol of irresponsibility and gambling.\(^\text{22}\)

Many saw bucket shops as places where “[p]roprietors and their customers bought and sold in small amounts, and their unlicensed transactions had only adverse bearing on exchanges taking place in ‘real’ markets.”\(^\text{23}\) The flourishing of this fragile shadow market began to erode the stability necessary for a growing economy, distorting the market and redirecting financial resources that could properly allocate risk to dead end financial instruments outside the market.\(^\text{24}\) More and more citizens, even wealthy investors, began to play the market in bucket shops rather than the actual market on real exchanges. This was depriving the market of the much needed lifeblood of investment and capital backing.\(^\text{25}\) Due to the opacity of the bucket shop market and its lack of regulation, the dangers hidden in this shadow market were not visible to most in the bucket shops or in legitimate exchanges.\(^\text{26}\) Their direct effect on the legitimate exchanges was effectively imperceptible at the time, as no bucket shop transactions were documented, and there was no way of knowing exactly how many bucket shops were in operation.\(^\text{27}\) The actual effect of such an alternate shadow market on a legitimate market is difficult to evaluate, and it is even harder to predict its potential to magnify any impending economic collapse.\(^\text{28}\)

It is also important to note the type of patron who frequented the bucket shop, for these were generally speculators of limited means and experience, betting rather than investing in a particular financial instrument.\(^\text{29}\) The majority of the time these patrons had little understanding of where their money was going or the risk involved in placing such wagers. The bucket shops were everywhere, and unlike the actual stock and commodities markets operating in a centralized location, the bucket shops came to the consumer as a decentralized entity independent from all other

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\(^\text{22}\) See Fabian, supra note 5, at 153–202.

\(^\text{23}\) Id. at 189.

\(^\text{24}\) See generally Hochfelder, supra note 7, at 350.

\(^\text{25}\) See Hochfelder, supra note 7, at 340, 345.

\(^\text{26}\) See generally 60 Minutes: A Look at Wall Street’s Shadow Market (CBS television broadcast Oct. 5, 2008) [hereinafter Wall Street’s Shadow Market].

\(^\text{27}\) See Hochfelder, supra note 7, at 345.

\(^\text{28}\) See generally The Bet That Blew Up, supra note 2.

\(^\text{29}\) See Hochfelder, supra note 7, at 337.
bucket shops and free from regulation.\(^{30}\) Also, in the case of the wealthy investor, bucket shops were a means of avoiding the regulations placed on legitimate markets when speculating in the economy. As mentioned, the margin necessary to trade was very little and thus reckless speculation, in effect gambling, carried with it little risk to such a wealthy patron, but had the potential for high rewards.\(^{31}\)

Additionally, the complete lack of regulation and documentation of the bucket shops and their transactions made them particularly susceptible to intentional or unintentional fraud.\(^ {32}\) The majority of the bucket shops had little capital backing the bets that they took from patrons. For the most part, they relied on the majority of losing bets to pay for the rare few that did win. Due to a lack of regulation mandating that a certain percentage of capital be had for the number and size of bets taken, in the event that the majority of patrons had correctly speculated, the bucket shop would not have enough to cover all its winning bets. In this instance, the bucket shop would simply fold up, close its doors, and disappear with all the money, only to open at another location soon after.\(^ {33}\)

Furthermore, many bucket shops would also rig the prices with wash sales to the detriment of both the patron and the legitimate market as a whole.\(^ {34}\) As most of the bucket shop patrons tended to be “bulls,” those that bet the prices of stocks or commodities would rise rather than fall, bucket shops would manipulate the legitimate market to drop the price of a stock or commodity. This practice was known as a “wash sale” because bucket shops, upon noticing that a significant number of their patrons had bet on a particular stock or commodity to rise, would place an order on the legitimate market to sell the particular stock well below its current price, thus “washing down” the price.\(^ {35}\) The effect that the wash sales had on the market came to be known as the “bucket shop drive.”\(^ {36}\)

One of the greatest effects that bucket shops had on the economy and the markets during their time, which cannot be measured in dollars or shares, was their effect on the perception of common citizens and financiers on the still young speculation economy developing in the United States. Bucket shops blurred the line between legitimate market speculation and mere gambling as our speculative economy and the bucket shop shadow market flourished together.\(^ {37}\) Bucket shops “seemed to foster the worst distortions of a speculative market and to feed exactly the cunning and greed that had long threatened the republic of producers.”\(^ {38}\) Arguably the bucket shops’ greatest victims were the patrons who entered the bucket

\(^{30}\) See id. at 342.
\(^{31}\) See Bucket Shop Sharpness, supra note 12.
\(^{32}\) See generally Hochfelder, supra note 7, at 340.
\(^{34}\) See id. at 344.
\(^{35}\) Id., supra note 7.
\(^{36}\) Id.
\(^{38}\) Fabian, supra note 5, at 190.
shops actually believing they were trading in the actual stock or commodities markets, rather than the glorified gambling parlors.\textsuperscript{39}

Even as the dangers of bucket shops were exposed, the unfettered speculation and illegitimate transactions that bucket shops promoted continued in the face of a growing opposition. The shadow market of bucket shops grew along with the economy in the late 1890s and early 1900s. It took a shock to the economy in the form of the Panic of 1907, and the subsequent regulation of both legitimate and illegitimate forms of speculation to bring about the end of buckets shops in the early twentieth century.\textsuperscript{40}

C. Bucket Shops Set the Stage for the Panic of 1907

Financial crises throughout history “result from a convergence of forces, a ‘perfect storm’ at work in the financial markets.”\textsuperscript{41} The Panic of 1907 was no different, and as we begin to sort through the causes of our current economic crisis, we will begin to see the forces that caused the perfect storm we are weathering today. Bucket shops were a large part of the unfettered speculation, which weakened and distorted the market, and as some suggest, “this unfettered speculation contributed to the panic and stock market crash of 1907.”\textsuperscript{42} As mentioned before, the very nature of the bucket shop, as proprietors of unregulated and undocumented gambling transactions, makes it hard to precisely calculate the role that they played in the Panic of 1907, for the damage done by a shadow market is difficult to evaluate when the entire market goes dark. Having evaluated the evils of bucket shops though, one begins to see how they helped to create the backdrop upon which the events of the Panic played out, setting the stage for economic crisis.

The youthful economy in 1906 was booming, experiencing unprecedented growth and industrialization; between the mid-1890s and the end of 1906, the nation’s annual growth rate was 7.3%, and between 1904 and 1906 alone, the Dow doubled in size.\textsuperscript{43} Companies were becoming corporations and capital was pouring into America’s factories and infrastructure.\textsuperscript{44} Every sector of the economy seemed to be growing and strengthening, from agriculture to railroad transportation.\textsuperscript{45} Larger than life financiers also began to emerge; the “Wall Street Oligarchs” were blazing a trail of prosperity for the United States economy and amassing untold wealth and power, the most legendary and influential being J. Pierpont Morgan.\textsuperscript{46}

\textsuperscript{39} See id.
\textsuperscript{40} See No Bucket Shops for New Law to Hit, supra note 8; Wall Street’s Shadow Market, supra note 26.
\textsuperscript{42} The Bet That Blew Up, supra note 2.
\textsuperscript{43} BRUNER & CARR, supra note 41, at 7; MITCHELL, supra note 37, at 167.
\textsuperscript{44} See generally BRUNER & CARR, supra note 41, at 8.
\textsuperscript{46} See BRUNER & CARR, supra note 41, at 10.
With the economy and its players in such a state of euphoria, speculation was rampant, as faster and higher returns were demanded by small and large investors alike.\footnote{See \textit{Mitchell}, supra note 37, at 198; Wilson, supra note 45, at 6.} With speculation flourishing on the legitimate exchange, it is no wonder why bucket shops were booming as well. They had expanded their operation and evolved from the once simple independent gambling parlors to more professional establishments, playing a greater role in the economy than ever before. As the \textit{New York Times} observed in 1905:

\begin{quote}
[In the last three or four years the bucket shop business has become so well organized that it has its direct influence even on the New York Stock Exchange, and the fact is beginning to be recognized. At least 90 percent of the business is backed by a few men commanding an immense amount of capital. Instead of there being thousands of bucket shops all over the country, each backed by an individual of limited resources, as in the old days, there are now several bucket shop systems maintaining headquarters in New York, Boston, Chicago, and Philadelphia.\footnote{\textit{Bucket Shop Systems}, supra note 10.}
\end{quote}

A key feature in the evolution of the bucket shops during this period was their interconnectedness. Through this interconnectedness, their complexity emerged; along with the increase in capital the heads of these consolidated bucket shops controlled, and thus deprived the actual exchanges. While the size of bucket shop operations and the amount of capital pouring into their market may have grown, the practices of the bucket shops, which brought them their initial and continued success, remained the same. They were engaging in wash sales, only now on a larger scale, affecting the market even more, and were still willing to close up shop should patrons place too many winning bets.

The dangers of bucket shops and their growing shadow market were magnified due to their evolution, and their ability to wreak havoc on a market in need of stability would soon be realized. As mentioned before, during this time there was little regulation over speculation occurring in legitimate exchanges, and nothing regulating the growing bucket shop market. The calls to regulate or eliminate the shadow market were ignored by those greedily indulging in it, hoping for a big payout. Before the Panic of 1907, the warning signs were surfacing and the impossibility of maintaining the exponential economic growth was becoming apparent, and “in 1906 the scholars in the field of economics were of the opinion that the loss of capital caused by wars and catastrophes, together with the craze for speculation, would cause a great strain upon the financial systems of the world.”\footnote{Wilson, supra note 45, at 6.} The shadow market of bucket shops at its peak in size, influence, and control of capital had darkened the economic skies. Soon the storm would begin and panic would sweep the nation.

In April of 1906, with the United States and world economies having funded the Spanish-American War, the Boer War, and the Russo-Japanese
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War, the San Francisco earthquake hit causing catastrophic destruction. This was a shock to the already weakened economy of the United States. By this time, the seemingly endless supply of capital generating the growth of our economy had ceased, and with the recent wars and the catastrophic earthquake that set San Francisco ablaze, this supply was being drained leaving little to back the highly speculative United States economy that had developed. Relief funds and gold reserves from New York and around the world were migrating to San Francisco.

Money now began to tighten and capital was scarce. The once exuberant players and speculators in the market were losing confidence and began to liquidate their assets and investments, removing further capital from the already struggling economy. The stock market began to falter and investors began to pull out, causing a slackening in trading. The lack of confidence in the market and atmosphere of capital stringency put the United States in a state of credit anorexia. There were few willing to loan money, purchase bonds, or take any risk in a market so fragile and unstable.

With the capital reserves of New York City and the rest of the United States depleted, one final act of failed “speculative jugglery” would help push the now fragile market over the edge. Two wealthy financiers, Fritz Augustus Heinze and Charles W. Morse, in hopes of bringing up the stock price of Fritz’s own United Copper Company (“UCC”), which had fallen in the slumping economy, executed a very risky and desperate financial maneuver known as the “bear squeeze.” When this risky speculation failed, the dominoes began to fall; and as the stock of UCC fell, it took every bank and trust company that had backed the highly speculative deal with it. The brokerage houses that had purchased UCC stock on the margin, at the request of Heinze and Morse, also folded, having received no payments from them. In the aftermath, the New York Times reported, “the ramifications of the failure and the possible consequences of the utter collapse of United Copper had a disastrous effect on Stock Exchanges sentiment.”

Few suspected that the Knickerbocker Trust Company, the third largest trust company in the country, headed by its reputable president Charles Barney, would be involved in the dealings of Hienze and Morse. A week after their failed scheme, however, the members of the Knickerbocker

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50 See id. at 6–7. The Spanish War (1898), the Boer War (1899–1902), and the Russo-Japanese War (1904–1905).
51 See BRUNER & CARR, supra note 41, at 13.
52 See Wilson, supra note 45, at 7.
53 See BRUNER & CARR, supra note 41, at 14–15.
54 Id. at 19–27.
55 Id. at 23.
56 Id. at 34.
57 BRUNER & CARR, supra note 41, at 37–38; Wilson, supra note 45, at 16.
58 BRUNER & CARR, supra note 41, at 44. The ultimate goal of the bear squeeze was to force speculative traders who had engaged in the short selling of borrowed shares to repurchase shares at a higher price, by driving it up through majority ownership. Such a financial maneuver is so risky, because it requires purchasing a lot of the stock in a company, and many times it is done on the margin.
59 See id. at 51.
60 Id.
board asked Barney to resign. Shortly thereafter, the National Bank of Commerce, which had agreed to act as the trust’s sole clearing house agent, announced that it would no longer clear for Knickerbocker.\textsuperscript{61} It was later revealed that Barney, as president of Knickerbocker Trust, had major holdings in numerous Morse controlled interests, and “the connection between Barney and the Heinz-Morse group had so engendered distrust that the feeling made itself felt by a succession of unfavorable balances.”\textsuperscript{62} This distrust generated a sense of panic, and a rush of withdrawals from Knickerbocker had begun. Soon it became apparent that Knickerbocker Trust would not be able to survive the run. The trust was eventually forced to close its doors, no longer able to return their customers’ deposits.\textsuperscript{63}

The Panic was now in full force, as the \textit{New York Times} reported on October 23, 1907: “[a]ll New York was swept by the ever-growing money panic today.”\textsuperscript{64} The contagion spread fast and soon there were lines at every bank and trust company full of people eagerly waiting to withdraw their funds, trying to escape the fate of those who had lost all their deposits when Knickerbocker folded.\textsuperscript{65} The panic that had gripped the nation then spread to the New York Stock Exchange, with prices plummeting as banks and trust companies continued to pull out of the market.\textsuperscript{66} With the Stock Exchange crumbling, the brokerage houses faced closure as well.\textsuperscript{67} All of Wall Street was pushed to the brink.

The economy was feeling the pains of having relied so heavily on speculation as opposed to sound investment, on a shadow market rather than the legitimate exchanges that it had overtaken. Through legitimate and illegitimate speculation, the economy had grown at a record pace, but it did not contain the matching capital necessary to support such growth. Despite the millions of dollars once being traded in bucket shops, the lack of actual investment made it very easy for bucket shops, which had come to control an immense amount of capital, and their speculating patrons to abandon the market. There were no assets owned, nothing of value beyond the original bet placed in a shadow market. The speculation, which had been so popular, slowed as people began to get out of the market. Bucket shops during this time did not fare well either, as it is hard to make any money when the market trend is a steady and predictable decline.\textsuperscript{68} The bucket shops, like the trust companies and banks, flooded out of the market, dumping the stocks that they had owned as a means of manipulating prices on the market, and driving it down even further.

The capital resources, which could have been used to maintain economic stability in the face of wars, catastrophes, and a slumping economy, were nowhere to be found. They remained in the pockets of the

\textsuperscript{61} See Wilson, \textit{ supra} note 45, at 23. A clearing house is a financial services company that provides clearing and settlement services for financial transactions.

\textsuperscript{62} BRUNER & CARR, \textit{ supra} note 41, at 76; Wilson, \textit{ supra} note 45, at 23.

\textsuperscript{63} See id. at 84.

\textsuperscript{64} Wilson, \textit{ supra} note 45, at 31.

\textsuperscript{65} See id. at 33.

\textsuperscript{66} See BRUNER & CARR, \textit{ supra} note 41, at 99.

\textsuperscript{67} See id. at 100.

\textsuperscript{68} See \textit{No Bucket Shops for New Law to Hit}, \textit{ supra} note 8.
bucket shop patrons or the buckets shops that had closed in the declining market. The shadow market had been depriving the legitimate markets of capital resources able to provide the liquidity desperately needed as the panic spread, and credit anorexia struck. When the panic hit, the shadow market disappeared along with the speculation craze that had fueled it, and all that remained was the hollow economy, which it had eroded over time. It is important to note that while the dangers of bucket shops were apparent before the Panic, their true effects emerged only when the economy was placed under great stress from other economic events.

Before the Panic subsided and confidence was restored, “the nation’s de facto central banker,” J.P. Morgan, in conjunction with other financial institutions, and minimal help from our government, would have to pour the necessary capital into failing banks, trust companies, brokerage houses, and the New York Stock Exchange just to keep the United States economy afloat. This necessary capital was what the bucket shops had been depriving the market of all along. J.P. Morgan emerged from the Panic as the savior of New York City, singlehandedly rescuing a number of financial institutions multiple times. For instance, he agreed to underwrite $40 million in New York City bonds, he lent $3 million to the Trust Company of America, and after calling a meeting of the New York trust company presidents and securing their assistance, he lent them another $8.25 million. He also assisted in raising $25 million in order to support the New York Stock Exchange.

With cash reserves across the nation seriously depleted, clearing houses began issuing clearing house loan certificates in place of cash payments for deposits to help prevent any further loss of capital reserves. By the end of panic, $250 million worth of these certificates had been issued across the country. Also, several banks nationwide either limited payments, suspended payments, or took banking holidays in hopes of quelling the panic and the rush to withdraw funds that had swept the nation. As the public became aware that the government would be receiving further gold shipments, and that the United States Treasury was issuing $40 million in gold bonds to the national banks, their confidence was gradually restored.

The dust finally settled around January 1908, with the most intense period of the Panic spanning the fifteen months between September 1906 and November 1907. At least twenty-five banks and seventeen trust companies failed, commodity prices fell 21% the value of all listed stocks declined 37%, and unemployment rose from 2.8% to 8%. At the time, this was the worst economic crisis we had faced in our history. It came to be

69 MITCHELL, supra note 37, at 168. See generally BRUNER & CARR, supra note 41, at 115–140.
71 Id.; BRUNER & CARR, supra note 41, at 95.
72 BRUNER & CARR, supra note 41, at 100.
73 See Wilson, supra note 45, at 35.
74 BRUNER & CARR, supra note 41, at 135.
75 See Wilson, supra note 45, at 53–41.
76 BRUNER & CARR, supra note 41, at 138–39.
77 BRUNER & CARR, supra note 41, at 151; Wilson, supra note 45, at 45–46.
78 BRUNER & CARR, supra note 41, at 141–42, 151.
known as the “1907 Bankers’ Panic,” due to the runs on banks and trust companies which generated the crisis. With the conclusion of the Panic and the economy beginning to stabilize, the attention of many turned to the causes of the Panic and the methods to prevent another from occurring.

D. THE REGULATION OF BUCKET SHOPS

In the wake of the Panic of 1907, the dangers of unfettered speculation, bucket shops, and the lack of proper economic safeguards, like a central bank and lender of last resort, were brought to light. What had become apparent was the need to put an end to the shadow market of bucket shops that helped weaken the market, making it susceptible to such a panic. The government took steps to put in place the proper safeguards to prevent an economic freefall like the one they just weathered. For instance, the Aldrich-Vreeland Act, enacted in May 1908, put in place “an emergency currency scheme to afford a method of issuing currency based on the reserves in banks.”\(^\footnote{79}\) Additionally, the Federal Reserve Act was enacted “to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking, and for other purposes.”\(^\footnote{80}\) Regulating bucket shops, however, proved more difficult, and it took multiple attempts to eradicate the shadow market entirely.

In the years before the Panic of 1907, there had been some attempts to outlaw bucket shops, but these failed, partly because of the difficulty in distinguishing between speculation and gambling. Additionally, bucket shops had become a prevalent and accepted part of the economy and of American society in general. Some anti-bucket shop laws were passed by states before the Panic of 1907, but they proved ineffective.\(^\footnote{81}\) The regulations on bucket shops were hard to impose, for it was difficult to draft legislation that would outlaw bucket shops without stifling legitimate speculation.\(^\footnote{82}\) When the Chicago Board of Trade attempted to draft bucket shop regulations, they concluded, “[s]peculation and gambling were alike, the board admitted, but the evil was incidental to the one and essential to the other.”\(^\footnote{83}\) In the war against bucket shops, “exchange officials and allied economists slowly and painstakingly constructed a distinction between speculation and gambling as a key weapon.”\(^\footnote{84}\)

In addition to establishing the distinction between speculation and bucket shop gambling, the legitimate exchange officials and regulators sought to deprive the bucket shops of their lifeblood by blocking access to stock and commodity price quotations.\(^\footnote{85}\) The early attempts at removing the tickers from bucket shops were unsuccessful. Most bucket shops were able to receive injunctions that prevented telegraph companies and the

\(^{79}\) Id. at 143–44.
\(^{80}\) Id. at 146.
\(^{81}\) See FABIAN, supra note 5, at 197.
\(^{82}\) See Hochfelder, supra note 7, at 349.
\(^{83}\) FABIAN, supra note 5, at 188.
\(^{84}\) MITCHELL, supra note 37, at 350.
\(^{85}\) See id.
exchanges from removing their tickers.\textsuperscript{86} Judges deciding the issue could find little reason to deprive the bucket shops of the price quotations, ruling that “there was scant moral and economic difference between trades on the exchange floor and transactions in bucket shops.”\textsuperscript{87} Moreover, the bucket shops also had a powerful ally in the telegraph companies, like Western Union, who did not want to lose such a lucrative client.\textsuperscript{88}

In 1905, writing for the majority in \textit{Board of Trade of the City of Chicago v. Christie Grain & Stock Company}, Justice Oliver Wendell Holmes delivered the first blow to bucket shops by ruling that the Board of Trade’s collection of price quotations was “like a trade secret.”\textsuperscript{89} The Board then had the right to prevent the bucket shops across the nation from using their price quotations to make bets. Holmes had drawn the distinction between legitimate speculation and bucket shop gambling saying:

Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want. It is true that the success of the strong induces imitation by the weak, and that incompetent persons bring themselves to ruin by undertaking to speculate in their turn.\textsuperscript{90}

While this decision was the first step in eliminating bucket shops, it was not the silver bullet that many had hoped. It would take a push from the Panic of 1907, changing the public sentiment, along with a change in the operation of legitimate exchanges to entirely eradicate bucket shops.

Deprived of the price quotations and threatened with closure, bucket shops became more elusive and received their price quotations in a variety of clever ways. In the event a bucket shop was raided and closed, no sooner would it open again in a different place under another name.\textsuperscript{91} Bucket shops also obtained price quotations by illegally stealing the prices through the telegraph or telephone.\textsuperscript{92} In extreme cases, bucket shop proprietors would rent offices with better views of the exchange floor and hire spies to steal prices.\textsuperscript{93} Even as the opposition to bucket shops grew and strengthened, they were still flourishing, offering services in great demand by the public.

As mentioned, when the Panic of 1907 hit, the dangers of the shadow market fueled by bucket shops were exposed to the public and their once eager patrons. The tide had turned in the war against bucket shops. Bucket shops were already weakened by the Panic of 1907, and with the public now weary of risky speculation, few were returning to bucket shops.\textsuperscript{94} Additionally, the legitimate exchanges had opened their doors to the common citizen, lowering the amount of capital necessary to enter the
market, and encouraging responsible investment in the market.\textsuperscript{95} With the opposition to bucket shop regulations fading, states across the nation began to outlaw buckets shops. As the \textit{New York Times} reported in September 1908 on the new bucket shop law, “the new law makes it a felony to operate a bucket shop or to be in any way connected with one, and the punishment is a fine of $5,000 if the offender is a corporation or imprisonment for five years or a fine of $1,000, or both, if an individual.”\textsuperscript{96}

The anti-bucket shop law in New York was “modeled on the legislation which successfully killed the bucket shop industry in Massachusetts and Ohio, both of which States were former strongholds of the evil.”\textsuperscript{97} Many bucket shops, upon notice of this law being enacted, closed up shop never to return. So, when the law did come into effect there were, as the \textit{New York Times} headline announced, “No Bucket Shops for New Law to Hit.”\textsuperscript{98} With bucket shops and their evils eradicated, new investors began to pour into the legitimate exchanges. As the \textit{New York Times} reported on the day New York enacted its anti-bucket shop law:

\begin{quote}
[T]he Exchange authorities estimate that in New York State alone the orders which used to go into the branch offices of the buckets up the State and in the headquarters here would have increased the legitimate trading on the two Exchanges from 200,000 to 500,000. . . . [L]egitimate houses having wire connections in the smaller cities have already profited by much small business which formerly went to the bucket shops.\textsuperscript{99}
\end{quote}

States across the nation began to follow suit and once the strongholds of bucket shops fell, all that remained were bucket shops in smaller towns. Eventually, by the end of 1915, William Antwerp of the New York Stock Exchange pronounced the bucket shop dead, thanking the efforts of the major exchanges and the “support of public opinion, the courts, the legislatures, the public service commissions, and the press.”\textsuperscript{100}

The enormous and unregulated shadow market of bucket shops had been defeated, and after learning its lesson, the United States instituted the proper regulations to make sure the shadow market would never rise again. Nearly a hundred years later, however, another financial instrument would emerge, maintaining the same risky and dangerous characteristics for which bucket shops were originally banned, but under a different name and with greater complexity. New life would be breathed into the bucket shops and their shadow market, with the lifting of their ban by Congress in 2000. This time, however, rather than merely setting the stage for an economic crisis, as bucket shops had done in the Panic of 1907, their modern day counterpart would be the centerpiece in an economic crisis which would rival any throughout our history.\textsuperscript{101}

\begin{footnotes}
\item[95] See \textsc{Mitchell, supra} note 37, at 192–208.
\item[96] \textit{No Bucket Shops for New Law to Hit, supra} note 8.
\item[97] Id.
\item[98] Id. See also \textit{The Bet That Blew Up, supra} note 2.
\item[99] \textit{No Bucket Shops for New Law to Hit, supra} note 8.
\item[100] \textsc{Hochfelder, supra} note 7, at 355.
\end{footnotes}
III. THE EMERGENCE OF CREDIT DEFAULT SWAPS AND REBIRTH OF THE SHADOW MARKET

A. CREDIT DEFAULT SWAPS EMERGE

In the late 1990s, financial innovators were looking for new ways to allocate and offset the risk banks carried in their lending and bond portfolios.102 The particular risk these banks were carrying was credit risk—“the risk that they would not be repaid money they had loaned to other companies.”103 The bankers at J.P. Morgan, relying on the math and science skills of MIT and Cambridge graduates to deconstruct the credit risk they were carrying, created a complex financial instrument that effectively “enables one party to transfer its credit risk exposure to another party.” This instrument would come to be known as the credit default swap (“CDS”).104 As Terri Duhon, one of the originators of J.P. Morgan’s CDSs stated, “[CDSs] made it possible for banks to get their credit risk off their books and into nonfinancial institutions like insurance companies and pension funds.”105 Transferring this risk and allowing banking institutions, like J.P. Morgan, to take this risk off of its books, freed up their capital reserves that were once required to be held as protection in the event any of the outstanding loans they had granted defaulted.106 With this new capital freed, they would be able to make more loans and purchase more CDSs on these loans as needed.

In their infancy, CDSs were fairly tame and prudent financial instruments for hedging risky ventures and loans. A typical CDS contract during this period would involve two parties; a protection buyer, typically commercial lenders or banks; and the protection sellers, typically insurance companies, investment firms, or hedge funds.107 These contracts could contain any provision agreed upon by the parties, facing no regulations or oversight. They are considered “Over the Counter” (“OTC”) transactions, because they did not go through an official exchange, but were dealt with directly between the parties.108 The protection buyer pays a periodic fixed premium or one-off payment to the protection seller, and in return the seller agrees to compensate the buyer for any loss resulting from a “credit event” incurred by a particular “reference entity.”109 Typically, the “credit events” in a CDS contract include bankruptcy, failure to pay, and restructuring.

102 Gretchen Morgenson, Arcane Market is Next to Face Big Credit Test, N.Y. TIMES, Feb. 17, 2008, at A1.
103 FRANK PARTNOY, INFECTIOUS GREED 375 (2003).
105 Philips, supra note 104.
106 See id.
109 See CHOWDHRY, supra note 104, at 16; Lynch, supra note 107, at 1384.
The “reference entity” is the third party whose performance is relevant: this can be single debt security or a portfolio of different debt securities.\textsuperscript{111}

CDSs are derivative instruments, as the value of a CDS is derived not from the CDS itself, but on the likelihood of a particular reference entity incurring a particular triggering credit event or not.\textsuperscript{112} Those who purchased CDSs were in effect making a side bet that a particular debtor or debt security would default.\textsuperscript{113} At this stage in the CDS market, CDSs were used primarily as protection against default on an asset a bank owned, but it would not take long for them to develop into the derivative instruments resembling the wagers placed in bucket shops.\textsuperscript{114}

As the twentieth century was coming to a close, CDSs were growing fast, and a shadow market was on the horizon. Those engaging in CDS transactions during this period were primarily banks acting as the protection buyer, hedging their risky loans with protection sellers. Additionally, the contracts were costly and “heavily negotiated” between the parties.\textsuperscript{115} CDS transactions, however, were emerging as a “liquid but opaque forum for secondary market trading of banking assets . . . often not observable by third parties.”\textsuperscript{116} Due to these characteristics it is hard to calculate the size of the CDS market prior to 2000, but estimates have it around $100 billion.\textsuperscript{117}

The CDS market, through its gradual evolution, was beginning to resemble the shadow market of bucket shops, and as this young market emerged, many potential regulators and economists began to level many of the similar criticisms once brought against bucket shops. Both markets were unregulated and required no reporting or documentation. Both were extremely opaque, making the actual size of each market difficult to calculate. Also, even though both CDSs and bucket shops were initially seen as rather benign, people had little idea of what effect they would have on the market. Like bucket shops patrons of the past, many believed those dealing in CDSs did not fully understand their risks.\textsuperscript{118} Additionally, there were no requirements placed on the sellers of CDSs to ensure that they would be able to pay their obligations in the event of default. One reporter commenting on J.P. Morgan’s use of CDSs wrote, “For now, practitioners can only hope that when it comes to credit derivatives, Murphy’s Law doesn’t apply.”\textsuperscript{119}

As the CDS market grew and evolved, Wall Street, which was beginning its extremely profitable love affair with CDSs, feared regulations

\textsuperscript{111} Ian Bell & Petrina Dawson, \textit{Synthetic Securitization: Use of Derivative Technology for Credit Transfer}, 12 DUKE J. COMP. & INT’L L. 541, 551; Lynch, supra note 107, at 1384.

\textsuperscript{112} See \textit{The Bet That Blew Up}, supra note 2.

\textsuperscript{113} Id.


\textsuperscript{116} Antonio Nicoles & Loriana Pelizzon, \textit{Asymmetric Information and Opacity in Credit Derivatives Market}, in \textit{CREDIT DERIVATIVES HANDBOOK} 57, 57 (Greg N. Gregoriou & Paul Ali eds., 2008).

\textsuperscript{117} See \textit{The Bet That Blew Up}, supra note 2.

\textsuperscript{118} PARTNOY, supra note 103, at 377.

\textsuperscript{119} Zweig, supra note 104.
from various overseers of the United States economy. The Securities and Exchange Commission (“SEC”) believed they could potentially regulate these new instruments requiring reporting and standards, as CDSs dealt primarily with debt securities. Also, the Commodity Futures Trading Commission (“CFTC”), which oversees the trading of futures contracts, relatively similar to CDSs, had been proposing some regulatory oversight as the CDS market began to grow. Lastly and most importantly, as the CDS market grew to resemble the shadow market of bucket shops, the state anti-bucket shop and gambling laws that successfully outlawed those instruments after the Panic of 1907 remained. Thus, our government would have to decide how to define the CDS and its market, providing the legal certainty and framework necessary to ensure the stability of our economy by preventing these new financial instruments from developing into “financial weapons of mass destruction.”

B. CONGRESS RESURRECTS MODERN DAY BUCKET-shops AND THEIR SHADOW MARKET

On December 15, 2000, the last day and the last vote of a lame duck Congress under former President Bill Clinton, the Commodities Futures Modernization Act of 2000 was passed unanimously and without debate. The stated purpose of the bill was “[t]o reauthorize and amend the Commodity Exchange Act to promote legal certainty, enhance competition, and reduce systemic risk in markets for futures and over-the-counter derivatives, and for other purposes.” Congress, through the passage of this bill, successfully created what SEC Chairman Christopher Cox would call in October 2008 before the Senate Banking Committee, “a regulatory black hole” in which the shadow market of CDSs would flourish. Harvey Goldschmid, professor at Columbia and former chairman and general counsel of the SEC, believes “the bill was passed at the height of Wall Street and Washington’s love affair with deregulation, an infatuation that was endorsed by President Clinton at the White House and encouraged by Federal Reserve Chairman Alan Greenspan.” Senator Phil Gramm, who co-sponsored the bill, “crowed that the new law, ‘protects financial institutions from over-regulation . . . and it guarantees that the United States will maintain its global dominance of financial markets.’” Congress had put their faith in Greenspan and his laissez faire attitude. Greenspan had put his faith in Wall

121 BERKSHIRE HATHAWAY, supra note 1.
122 See The Bet That Blew Up, supra note 2.
125 See The Bet That Blew Up, supra note 2.
Street, believing it could be trusted, saying, “[t]here is a fundamental trade-off of what type of economy you wish to have . . . . You can have huge amounts of regulation and I will guarantee nothing will go wrong, but nothing will go right either.” Congress had been sold on the idea that it could only get in the way of our ever-growing markets and financial successes. It was agreed that Wall Street should be left to its own devices, and if that meant rolling back regulations on arcane financial instruments that had brought down our market in the past, so be it.

There was some opposition to the Act, but it came mostly from the regulators who were seen as the problem, not the solution, during the golden age of Wall Street. Brooksley Born, who headed the CFTC at the time, prophetically warned that CDSs would “threaten our regulated markets, or indeed, our economy, without any federal agency knowing about it.” Greenspan responded to the calls for regulation by saying that CDS regulations could potentially cause a financial crisis. The United States Treasury lawyers who opposed regulations went so far as to conclude that “merely discussing new rules threatened the derivatives market.” It was clear, as the Treasury secretary at the time, Robert Rubin, stated, “[a]ll the forces in the system were arrayed against it . . . . The industry certainly didn’t want any . . . . There was no potential for mobilizing public opinion.”

The bill addressed the three major regulatory concerns facing CDSs and its growing shadow market. Title I of the bill “excluded swap transactions” from the Commodity Exchange Act (“CEA”). The CEA and its subsequent amendments were intended, in part, to strengthen commodities futures regulation and prevent modern day bucket shops from emerging in new complex futures markets, like the CDS market. With CDSs excluded from the CEA, the CFTC, which was created and granted authority under the Act, was unable to reach CDSs. Title III of the bill, named “Legal Certainty for Swap Agreements,” excluded CDSs from the definition of “security” under both the Securities Act of 1933 and the Securities Exchange Act of 1934. By removing the CDS from the definition of security, Congress also removed the SEC’s ability to regulate CDS transactions. These two provisions effectively eliminated any potential federal oversight of CDSs. It seems that by excluding CDSs from the definition of commodities futures and securities, Congress was shifting CDSs away from the legitimate and regulated speculation that had been encouraged after the Panic of 1907, and moving towards the bucket shop speculation that had been rampant prior to the Panic.

127 Goodman, supra note 101.
128 See The Bet That Blew Up, supra note 2.
129 Leiber, supra note 115.
130 See Goodman, supra note 101.
131 Id.
132 Id.
136 See Leiber, supra note 115.
Moreover, the restrictions that Congress put on CDS transactions seemed only to fuel the shadow market, making it more opaque and limiting its participants to financial institutions and wealthy Wall Street speculators. The bill excluded swap agreements provided that the transaction was: “(i) entered into only between persons that are eligible contract participants at the time they enter into the transaction, (ii) subject to individual negotiation by the parties and (iii) not executed or traded on a trading facility.” 137 “Eligible contract participants” generally include financial institutions, insurance companies, brokers, traders, investment banks, and certain governmental entities. 138 As an example of some of the specific requirements, corporations must “have more than $10 million in assets (or are supported by certain keepwell or other arrangements, or have a net worth of more than $1 million and enter into the transaction for certain risk management purposes).” 139 Also, for an individual to be considered an eligible participant, he or she needed “total assets in excess of $10 million or they have total assets in excess of $5 million and the transaction is entered into for risk management.” 140 The “eligible participant” provision kept the CDS market out of reach for anyone but the wealthiest of investors. While this is different from the bucket shops of the past, it appears that the legislature, aware that they bore similar risks, wished to institute financial barriers to prevent the unsophisticated investor from engaging in these risky speculations. The remaining requirements placed on CDSs—that they be subject to individual negotiation and not executed on a trading facility—laid the foundation of the shadow market. Other than the bucket shop shadow market of the past, there exists no more opaque market than one that faces no regulations, requires no formal exchange, and promotes unique and undocumented transactions.

With Congress effectively legislating the shadow market of CDSs into existence through the removal of any federal oversight, the final step in resurrecting the modern day version of bucket shops and their shadow market was to remove the laws that had once banned them following the Panic of 1907. On the last page of the bill, and in the very last clause the CFMA states: “PREEMPTION”—This title shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops (other than antifraud provisions of general applicability) in the case of— . . . (2) a covered swap agreement. 141 By enacting this final provision, Congress precluded states from regulating CDSs or those who bought or sold them; states were statutorily prevented from imposing their own bucket shop and gambling laws. 142 It appeared that Congress recognized the similarities that the CDS market, even in its infancy, had to bucket shops and gambling transactions, and in light of

138 Prezioso, supra note 157, at § III.A.1.
139 Id.
140 Id.
141 Id.
142 H.R. 5660, 106th Cong. § 408(c) (2000).
143 See The Bet That Blew Up, supra note 2.
these similarities drafted a specific exclusion to the prohibition of such activities with respect to CDSs.

Freed from all state and federal regulations, the shadow market was resurrected. From the ashes of the now long forgotten bucket shops, modern day corporate bucket shops emerged and began taking orders from “eligible participants.” The CDS became a more complex, higher stakes derivative wager, yet still maintained the risky and dangerous qualities of the simple bucket shop wagers of the past. It was unlikely that Congress knew the ramifications enacting the CMFA would have, for few actually understood CDSs, much less the effects that their complete deregulation would have on the market. In the years after the deregulation of CDSs, our economy was booming and the CDS market grew exponentially. It seemed that Wall Street could do no wrong.

With the advent of the housing boom, CDSs emerged as the perfect financial instrument to handle the new influx of loans that banks and lending institutions were granting. From 2000, after the passage of the CFMA until 2008, the shadow market of CDSs grew from an estimated $100 billion to between fifty and sixty trillion dollars.143

IV. THE UNRAVELING OF OUR ECONOMY—WALL STREET’S PERFECT STORM

A. THE STORM BUILDS

Just as with the Panic of 1907 and other financial crises, the current economic crisis resulted from a convergence of economic forces—a perfect storm.144 In the Panic of 1907, economists established that the bucket shop shadow market helped set the stage for financial collapse. As we explore the similar development of the storm that caused our current financial situation, we will see that as modern day bucket shops emerged and the shadow market once again overtook our legitimate and regulated exchanges, they became the “centerpiece” of our economic crisis.145

To truly understand how we got to where we are today, we must think back to a time much different from that which we now find ourselves—back to a time where economic prosperity and continued growth in all sectors of our economy appeared endless. A time when Wall Street financiers, investors, CEOs, and corporate players were viewed as brilliant leaders and economists, deserving of their huge salaries and mega-bonuses. A time when regulators continually looked for new areas to deregulate. A time when society encouraged common Americans to live beyond their means, buy a house, and rely on credit to fill the gap between what they wanted and what they could afford.

During this time the storm gradually began to build. After the dot-com technology bubble burst around 2001, investors were looking for new

143 See id.
144 See BRUNER & CARR, supra note 41, at 4.
145 Wall Street’s Shadow Market, supra note 26.
places to put their money. These investors turned to the real estate market, viewing it as a reliable investment producing consistent returns at low risk. A multitude of lenders fueled the market by doling out mortgages to anyone wanting to purchase a home. The housing markets in areas like California, Nevada, and Florida were the first to explode, and the rest of the country quickly followed. Soon the demand for homes became insatiable and housing prices began to soar; first time home buyers, second home buyers, and speculators poured into the market.

Mortgage companies and lenders, like Countrywide, IndyMac, Fannie Mae, and Freddie Mac, raked in profits. Wishing to expand further, these companies began looking for more borrowers. Further inflating the housing bubble, they began to offer mortgages to those with credit ratings below “A,” the so-called subprime mortgages. During this period, certain federal mortgage lending restrictions were lifted, allowing lenders to grant loans to individuals previously ineligible due to a poor credit rating or lack of resources. The mandatory minimum down payment for a mortgage became smaller, then non-existent or borrowed in addition to the mortgage. Also, proof of income went from requiring verification to merely stating one’s income to the lender, known as a “stated-income loan.” People purchased homes they could not afford, with mortgages they were unable to pay, and under terms they did not comprehend. In some instances, the terms of these mortgages contained rates that spiked after a certain period of time; the mortgage holder unaware of these terms could be forced into default upon the unexpected increase in payments. The housing bubble rapidly expanded, crammed with homeowners who had poor credit ratings, lived beyond their means, and on the brink of default.

As the housing bubble grew, and lenders began to issue more and more risky subprime mortgages, investment firms believed they had discovered a way to profit off these mortgages with little risk to an investor. They began to offer collateralized debt obligations (“CDOs”) to eager investors and banks. These CDOs “were actually designed by mathematicians and physicists who used algorithms and computer models to reconstitute the unreliable loans in ways that were supposed to eliminate most of the risk.” Soon the biggest names on Wall Street—Bear Sterns, Citigroup, Lehman Brothers, and Merrill Lynch—“were buying billions of dollars’ worth of subprime mortgages from non-bank lenders, securitizing them, and then resecuritizing them into CDOs.” These mortgage-backed

147 Id.
148 See id.
149 PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME: HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS 325 (2008) (defining a subprime mortgage loan as “a loan originated by a lender that is A- to D in quality. Consumers who have the best credit ratings with the highest FICO scores are considered ‘A’ credit quality.”); ElBoghdady & Cohen, supra note 146.
150 MUOLO & PADILLA, supra note 149, at 325.
151 ElBoghdady & Cohen, supra note 146.
152 See Lieber, supra note 115; Wall Street’s Shadow Market, supra note 26.
154 MUOLO & PADILLA, supra note 149, at 7. See also BLACK’S LAW DICTIONARY 1384 (8th ed. 2004) (defining “securitize” as “to convert (assets) into negotiable securities for resale in the financial market,
investment securities, or CDOs, were sold as new and creative investments that were safe, but not too safe, still allowing for high returns. Wall Street firms paid credit rating agencies, like Moody, Standard & Poor, and Fitch to assess the quality of these CDOs.\footnote{See CHAUDHRY, supra note 104, at 4; Washingtonpost.com, How Mortgages Became Part of the Mess, Dec. 16, 2008, WASH. POST, http://www.washingtonpost.com/wp-srv/business/interactives/frenzy/.} Each one of these agencies ranked the CDOs as investment grade, meaning the CDOs had a high creditworthiness.\footnote{See Wall Street’s Shadow Market, supra note 26. See also CHAUDHRY, supra note 104, at 5.} Investment firms made millions by selling CDOs among themselves, other investors, and to banks like Wachovia and Washington Mutual.\footnote{Lieber, supra note 115.}

\section*{B. Modern Day Bucket Shops Become the Centerpiece of the Crisis}

At this point, one may begin to see the financial house of cards taking shape. Wall Street, however, believed it could support this house with an additional financial instrument—the deregulated and little understood CDS. Reputable financial institutions that offered CDSs transformed into modern day bucket shops fueling the shadow market which grew unabated to an unfathomable size. CDSs were initially seen as the perfect instrument to protect a CDO investor from loss should the CDO fail or default. A person who purchased a CDO, comprised of risky subprime mortgages, from one investment firm, could go out and purchase a CDS from either the same firm or a different firm, thus transferring the risk of the CDO to a third party, the CDS protection seller.\footnote{See Janet Morrissey, Credit Default Swaps: The Next Crisis?, TIME, March 17, 2008; The Bet That Blew Up, supra note 2.} The CDS was essentially a side bet that the CDO would fail, and in the event it did, the CDS purchaser or bettor would get paid the money owed on the CDO from the CDS protection seller.\footnote{Varchaver & Benner, supra note 126.} CDSs made CDOs a much more marketable investment, and both markets fed one another. As the housing market grew, and more mortgages were issued, firms constructed more CDOs, and the shadow market of CDSs flourished.\footnote{See generally id.}

The markets for CDOs and CDSs grew at approximately the same rate between 2000 and 2003—market values around $5 trillion. During this time it appears that those purchasing CDSs in order to place side bets on CDOs were limited to those who actually owned these CDO mortgage-backed investment securities. However, after 2003, the CDS market grew exponentially, reaching $45.5 trillion by 2007, while the market for mortgage-backed securities gradually rose to only $7.1 trillion. During this period of rapid growth, the modern day bucket shops had opened their

allowing the issuing financial institution to remove assets from its books and thereby improve its capital ratio and liquidity while making new loans with the security proceeds.”).
doors and the subsequently created shadow market overtook all the legitimate markets of the United States economy.  

The tipping point occurred when Wall Street had figured out that millions could be made by simply purchasing a CDS without ever owning a CDO or any other underlying asset. Through the purchase of CDSs, investors began to make million dollar bets on whether people would default on their mortgages causing the CDOs to fail. Typically, a speculator would purchase a CDS in a one-off payment in hopes that a particular CDO would fail. Eventually the CDS market expanded beyond merely betting on the success of CDOs, since one could bet on the solvency of just about anything. A CDS would be a winning bet if the speculator successfully predicted the failure of a particular reference entity, such as a CDO or company. These transactions mirrored those placed in bucket shops before the Panic of 1907, though instead of betting on the rise and fall of stocks or commodities, the bets were placed on the success or failure of a CDO or company. Eric Dinallo, insurance superintendent for the State of New York and opponent of CDSs, said with regards to CDS transactions, “It’s legalized gambling. It was illegal gambling. And we made it legal gambling . . . with absolutely no regulatory controls. Zero, as far as I can tell.” The CDS market had evolved into the bucket shop shadow market of 1907, with uncanny similarities.

The major modern day bucket shops that emerged to take these CDS bets were American International Group (“AIG”), Bear Sterns, Lehman Brothers, J.P. Morgan Chase, Citibank, and Bank of America. Due to the CFMA of 2000 these bucket shop transactions faced no regulation, went through no exchange, and were completely undocumented. Unlike the bucket shop patrons of the past, the CDS shadow market was accessible only to the wealthiest investors and banks. The common citizen remained unaware of the billions being gambled in this market, arguably making the CDS market more opaque than the older bucket shop market. However, participants in both of these markets shared the common lack of understanding of both the financial instruments they were dealing with and the effects their bets would have on the legitimate markets. The complex and highly negotiated CDS transactions had become standardized, requiring little understanding of their technical aspects, bringing them ever closer to the bucket shop transactions of the past. Quite tellingly, the perception on Wall Street was that “CDS are easy to create: Often deals are done in a one-minute phone conversation or an instant message.” As bucket shops proliferated on Wall Street, the line between legitimate and responsible economic speculation and mere gambling, which judges,
regulators, and economists of the past had fought so hard to define and defend, was blurred once again.

Also, like the bucket shops of old, when these modern day bucket shops insured these unregulated CDS bets from speculators, they were not required to maintain any capital to cover these bets in the event they had to pay them off. With the overall United States prosperity and never-ending housing boom, modern day bucket shops thrived just as the bucket shops had during the early twentieth century. These modern bucket shops eagerly took wagers from speculators betting that risky mortgages, the substance of many CDOs, would default. While it may be hard to believe now, at that time, with the economy continuously growing, the possibility of default looked remote, if not impossible, so firms sold more and more CDSs, believing they would never have to pay out these bets. Due to this seemingly impossibility of default, “you could lay down cents on the dollar to place a bet on the solvency of Wall Street, for example, as some did, when Wall Street became evidently insolvent, that cents on the dollar bet went up 30, 40, and 50 fold.”

While these modern day bucket shops rode this wave of economic prosperity to record profits, many speculators, investment firms, and banks were poised to hit the jackpot in the event of economic collapse. A crucial aspect of the impending doom came from these speculators, investments firms, and banks that relied on these potential jackpots in the event of such an economic collapse. This instilled a reckless confidence that facilitated the engagement in risky investments and the spreading of capital even more thinly. This reliance on CDSs also created a layer of interconnectedness and complexity that placed the CDS market as the final backstop in a failing and unstable economy. Additionally, many failed to see the possibility of a systemic collapse within the CDS shadow market. CDSs had helped the house of cards rise higher by freeing up capital, while at the same time eroding its supports. Bucket shops, prior to the Panic of 1907 acted in a similar way by contributing to the speculative economy and growth, while at the same time depriving it of the foundational reserve capital which it would need during a time of economic stress and instability.

Just as in the years before the Panic of 1907, the shadow market overtook the legitimate markets and exchanges. By 2007 the shadow market had reached a total of $45.5 trillion dollars with 2008’s projections ranging from fifty to sixty trillion dollars. In comparison, the 2007 stock market was valued at $21.9 trillion, the mortgage-backed investment securities market at $7.1 trillion, and the United States Treasuries Market at $4.4 trillion—extremely large sums of money, yet even combined they did not exceed the value of the CDS market at the time.

The shadow market created by the old bucket shops before the Panic of 1907 negatively affected the legitimate exchanges and economy externally.

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168 Id.
169 See Morgenson, supra note 102; The Bet That Blew Up, supra note 2.
170 The Bet That Blew Up, supra note 2.
171 In the Shadow of an Unregulated Market, supra note 161. See The Bet That Blew Up, supra note 2.
172 In the Shadow of an Unregulated Market, supra note 161.
The shadow market in the early twentieth century, though even more limited in scope, contributed significantly to the Panic of 1907. Recently, Wall Street again embraced a shadow market and its modern day bucket shops which touched every exchange, bank, and investment firm. Our economy would turn to the modern day bucket shops in times of need to restore equilibrium in a failing economy. The CDS shadow market became so entangled with legitimate markets, exchanges, and institutions of the United States economy that it created a potential for economic disaster the likes of which we had never seen.

C. The Panic of 2008

The economic collapse which drove us into the current recession happened fast, with the financial dominoes falling in rapid succession. By the summer of 2008, the housing bubble had burst, inflation escalated to historic levels, and food and gas prices increased rapidly, with oil peaking at $147.30 a barrel. Consumer demand throughout all sectors of our economy dropped sharply. Additionally, as “incomes stagnated for most United States families, . . . consumer spending rose fueled by borrowed money. Mortgage payments became an ever heavier weight.”

Eventually, these mortgage payments became too much for some, especially when their complex and misunderstood terms caused the payments to skyrocket after a period of relatively small minimum payments. Defaults began to pour in, resulting in the initial thrust towards economic collapse. The influx of defaulting mortgages drove mortgage companies—most notably Fannie Mae and Freddie Mac—to the brink. Thus, with these lending institutions about to collapse, “officials seize[d] both Fannie Mae and Freddie Mac, temporarily putting them in a government conservatorship.” This would not be the last time the government would have to swoop in to save a company from bankruptcy in order to save the United States economy from utter failure.

While the mortgage crisis may sound bad, one must keep in mind that, ninety-four percent of Americans were still paying off their loans, and the six percent of defaulted mortgages during this time totaled about $1.2 trillion. This is certainly a lot of money, but not enough to cause the systemic economic failure we are seeing today. As mortgages began to default, the values of the CDOs that were comprised of these risky mortgages were dragged down as well. The banks and investors who loaded up on these CDOs were hurting, and financial institutions like

176 Lieber, supra note 115; Wall Street’s Shadow Market, supra note 26.
Wachovia, Washington Mutual, Merrill Lynch, and Lehman Brothers approached financial disaster. CDOs amplified the effects of the mortgage crisis, spreading its toxic effects throughout Wall Street. The CDS shadow market and the modern day bucket shops were now facing the added stress of an economic downturn, and we would soon discover just how these arcane financial instruments would react. As Frank Partnoy, a one-time derivatives trader, said, “We wouldn’t be in any of this trouble right now if we had just had underlying investments in mortgages. We wouldn’t be in any trouble right now.”

The major bucket shops of this time held billions and trillions in CDSs, and the shadow market had grown out of control. The CDS liability of these modern day bucket shops is difficult to grasp due to the shadow market they created. Additionally, many of the firms acting as bucket shops were also the shadow market’s biggest patrons, purchasing CDSs from other bucket shops as a means of hedging their bets. When the mortgages began to default and the CDOs began to fail, those who were betting against the market attempted to collect from firms like Lehman Brothers, Bear Sterns, AIG, and any others who had sold CDSs. These modern day bucket shops, just like the bucket shops of the past, had backed their CDSs with little capital and many found themselves unable to cover all their bets. The bucket shops of the early twentieth century folded up and disappeared when they were unable to cover their bets—in many cases the modern day bucket shops would be no different.

Bear Sterns was the first company to be hit with massive CDS obligations that it could not pay—some analysts said that Bear Sterns “held credit default swap contracts carrying an outstanding value of $2.5 trillion.” J.P. Morgan bought Bear Sterns for pennies on the dollar. Then Lehman Brothers, amidst pleas for government assistance and with no one willing to buy the company, declared bankruptcy. With these companies failing, people began to worry. Fortunately, these companies had been operating as both bucket shops selling CDSs and as patrons, hedging their bets by purchasing CDSs from other bucket shops. When the market began failing, these companies went under, because they could not cover their losses, even though they had attempted to offset potential losses through other CDS purchases. While the attempt to offset their losses failed, it did prove to prevent a catastrophic detrimental effect on the market. The market’s decline, however, continued, suffering through a mortgage crisis and the loss of two major financial institutions, while many other institutions lingered on the verge of demise. With the recent failure of Lehman Brothers and Bear Sterns, the attention of many turned to AIG, an institution that was carrying a lot of CDSs on their books.

178 Lieber, supra note 115.
179 Wall Street’s Shadow Market, supra note 26.
180 Philips, supra note 104.
182 Financial Meltdown Interactive Timeline, supra note 175.
183 Philips, supra note 104.
184 Id.
Even though the trading of CDSs was a relatively small part of AIG’s business, the sums of money being traded were enough to threaten the failure of the nation’s largest insurance company. AIG, unlike many of the investment firms dealing in CDSs, had not attempted to offset any losses by purchasing CDSs from other modern day bucket shops. Instead, it took in bets, “simply providing the swaps and holding onto them.” When the market began its slide, and AIG’s bucket shop patrons came to collect, it had nothing to give and had hedged nothing to prevent catastrophic losses. As AIG was teetering on the edge of collapse the government was forced to intervene. The government considered AIG too big to fail because it had too many legitimate interests and the bankruptcy of this insurance monolith would have been utter disaster. “The reason the federal government stepped in and bailed out AIG was that the insurer was something of a last backstop in the CDS market.” If AIG had been allowed to fail, the entire CDS market would have failed, and everyone who had purchased a CDS from AIG would have suffered huge losses, being unable to collect on previous guarantees. The foundation of our economy was crumbling, as each level of the financial house of cards failed. The fuse burned just shy of detonation, leaving scant moments before devastation in the wake of the implosion of the CDS market. Financial investors and institutions relied on their bucket shop bets to cover their losses should all their risky investments fail. When these risky investments did fail, it was the CDS shadow market alone holding up the economy.

So, the federal government stepped in and handed eighty-five billion dollars to AIG as an emergency rescue loan, “saying a failure of the insurer could have sent shock waves throughout global markets.” In the end, it was the government and the taxpayer who provided the final and only secure support for Wall Street’s house of cards. AIG’s stock plummeted and being part of the Dow Jones Industrial Average, “the plunge in its share price pulled down the entire average, contributing to the panic.” President Obama when asked on the White House lawn if it had been a mistake to bailout AIG said:

[T]hat wasn’t a decision that we made, but I actually think it was the right decision—AIG had insured a whole bunch of losses for a whole bunch of banks that had made bad bets on subprime loans and mortgages that had been packaged and bundled up and made into securities . . . . [H]ad AIG been allowed to simply liquidate and go bankrupt, all those banks who were counter-parties with AIG would have experienced such big losses that it would have threatened the entire financial system.

185 Lieber, supra note 115. See The Bet That Blew Up, supra note 2; Philips, supra note 104.
186 Philips, supra note 104.
187 Wall Street’s Shadow Market, supra note 26.
188 Philips, supra note 104.
189 Financial Meltdown Interactive Timeline, supra note 175.
190 Philips, supra note 104.
It was clear that the government had to step in and prevent the collapse of AIG to avert an economic collapse. Soon after the government gave eighty-five billion dollars to AIG, the deteriorating market forced the government to give AIG another sixty-seven billion dollars. Much of this money was used to pay off the counterparties or patrons of AIG bucket shop transactions. For the time being, the government had snuffed out the fuse and prevented the financial weapons of mass destruction from detonating.

As the crisis unfolded, no financial institutions which had also been a part of the shadow market of bucket shops, escaped from being adversely affected. Citigroup, another major player in the CDS market, received a forty-five billion dollar bailout package as well as a $300 billion loan package from the government.192 Again, most of this money seemingly disappeared into the hands of those who had purchased CDSs from the bucket shop known as Citigroup. While the major banks and investment firms did not fare well, many private individual investors who bet against the market profited, shamelessly collecting millions in winnings for these modern day bucket shops.

As the United States’s largest financial institutions were in turmoil, panic hit the United States economy. As a result, the government began pouring money into these institutions anticipating that it would turn the economy around, but the effects of such bailouts have been gradual if at all. The collapse of the CDS shadow market and the failure of many of the modern day bucket shops has sent our economy into a downward spiral rivaling the Panic of 1907 and even the Great Depression. It compares to the Panic of 1907, for the banks and investment companies themselves were the greatest contributors to the continued panic and additionally, just as in 1907, credit anorexia presented one of the major problems facing our economy. Today, even if banks have capital, they are reluctant to provide credit, fearing it will never be returned. Mortgage companies and banks once willing to engage in risky lending practices and investments lend much less, at higher interest rates, and only under the strictest standards.

With money becoming tighter, and with less lending, consumer spending dwindled. This lack of consumer spending dragged the market down further. The stock market became extremely volatile, with many losing entire 401(k)s or pension funds. The foreclosure rate reached its highest point in fifty years and continues to climb, while housing prices across the nation have plummeted. The unemployment rate steadily climbed to 8.1% in February 2009, eventually reaching 10%.193

While the government continues to take steps to stabilize our economy, and generate growth, it has also begun to look at the shadow market and the modern day bucket shops which got us into this mess. Many regulations have been proposed, and with lessons learned from the bucket shops of old, a regulatory scheme for CDSs can be achieved which can protect against

192 Lieber, supra note 115.
the dangers of bucket shops and the shadow market, ensuring the future
success of our economy.

D. BRINGING TRANSPARENCY AND REGULATION TO A ONCE
UNREGULATED SHADOW MARKET

While we neglected history once in resurrecting bucket shops through
the CDS shadow market, it would be equally awful to ignore history again
in attempting to solve the problem of the CDS shadow market and its
modern day bucket shops. As the call for more regulation—or in the case
of CDSs, any regulation at all—rings out from Congress we must be careful in
establishing new regulations and taking drastic actions in the current fragile
market.\textsuperscript{194} The tendency during an economic crisis has been to allow the
pendulum to swing in the direction of overregulation toward total oversight
of the market. In many cases this can be even more detrimental to an
already delicate market, by quashing growth and stifling investors, rather
than rebuilding confidence in the market and aiding those most affected by
the crisis. With these concerns in mind, it is, however, evident that the CDS
market is in need of a regulatory scheme to bring about more transparency
in this shadow market and the bucket shops it contains.

It is now recognized that no one fully understood the impact that CDSs
had on our market. Currently, Congress is holding multiple hearings and
forming committees to figure out what went wrong and what we should do.
Before we can establish any regulations on CDSs, we must first gain a
better knowledge of these financial instruments and their effects. Just as
Congress and state legislatures analyzed bucket shops in the aftermath of
the Panic of 1907, so too must our current government evaluate the CDS
market. As we begin to take a look at CDSs, its shadow market, and the
modern day bucket shops which fueled this market, their problems and
effects will be revealed. Even the once staunch proponent of deregulation,
Alan Greenspan, when dragged in front of the House and Senate said,
“Credit default swaps, I think, have some serious problems. . . .”\textsuperscript{195}

By better understanding the CDS market, we can better define the CDS
transactions, for “the fate of the credit-default swap market will largely rest
on how Congress defines these contracts in law.”\textsuperscript{196} CDSs are very unique
financial instruments which carry risks and rewards different from any
other. The governor of New York, David Patterson, announced in
September of 2008 that CDS transactions would be defined as insurance,
and would seek to apply the proper insurance regulations and requirements
on each CDS contract.\textsuperscript{197} While the swiftness of New York’s attempt at
regulating CDSs should be applauded, it is improper to place an existing
regulatory scheme, such as insurance regulations, on a unique and complex

\textsuperscript{194} See Shannon D. Harrington & Christine Richard, Credit Swaps Move Closer to Regulation with N.Y.
\textsuperscript{195} The Bet That Blew Up, supra note 2.
\textsuperscript{196} David Cho & Zachary A. Goldfarb, 3 Agencies Vie for Oversight of Swaps Market, \textit{WASH. POST}, Oct.
21, 2008, at D1.
\textsuperscript{197} Harrington & Richard, supra note 194.
financial instrument which has played such a central role in the fall of our economy.

While CDS transactions may share some of the qualities of an insurance contract, the reference entities from which people are buying protection against default differ greatly. Additionally, the role which CDSs play in our economy is much larger than the insurance contracts for which regulations were designed. As Tim Backshall, chief strategist of Credit Derivatives Research LLC stated about New York’s plan for regulating CDS transactions, “These ad hoc actions are more likely to cause further dislocation than help any realignment and normalcy.” Whatever regulatory scheme Congress may devise, it must take into account the dangers and benefits of CDS transactions, protecting against the former and promoting the latter.

CDSs are not all bad, and as Christopher Cox, Chairman of the SEC states, “Credit-default swaps are not inherently good or evil. They play an important role in the smooth functioning of capital markets by allowing a broad range of institutional investors to manage the credit risks to which they are exposed.” Our government after the Panic of 1907 was forced to draw a distinction between the legitimate speculation taking place in the markets and the illegitimate bucket shop transactions that were occurring. It must do this once again as it sorts through the CDS market evaluating the legitimate and illegitimate transactions that were occurring before this recent economic crisis.

Congress, after defining CDSs and analyzing its market, must select or create a proper agency or agencies and grant them the authority to regulate the market. An all hands on deck approach would be the best way to ensure the security and stability of the CDS market as we move into the future. The regulatory agencies from which Congress once removed regulatory power should now come together to regulate this market. The SEC is already spearheading the regulation of the CDS market. There has been discussion amongst the SEC, the CFTC, the Federal Reserve Board, state institutions, and major CDS players to decide how to regulate the CDS market. The more institutions which become involved in the process of establishing regulations on this market, the more seamless the regulatory scheme will be.

With the means of regulation established, we must next focus on the regulations that will be implemented to prevent the CDS market from growing out of control again. Transparency in the CDS market should be the most important goal of each regulation. Transparency is crucial in setting up a proper regulatory system which will turn the CDS market into

198 Id.
201 Id., Cox, supra note 199.
a legitimate market as opposed to a shadow market. The Chairman of the SEC agrees saying, “Transparency is a powerful antidote for what ails our capital markets . . . . By giving regulators the authority they need to bring the credit derivatives market into the sunshine, we can take a giant step forward in protecting our financial system and the well-being of every American.” The best way to create transparency is to force the CDS market into a single central clearinghouse or multiple clearinghouses. By doing so, each CDS transaction will be documented and the values of CDS contracts will be more easily assessed by those trading them. As we have seen, a market that resides in the shadows hides the risks it creates and hides its effects on the overall economy.

In addition to transparency, a clearinghouse would provide an important requirement for all CDS transactions, the requirement that CDS traders maintain a sufficient amount of capital to cover each transaction should a default occur. This would prevent a situation like the one we saw where companies were forced to declare bankruptcy because they could not cover their obligations. A clearinghouse could also act as a single counterparty to absorb a concentration of risk, “reducing the counterparty risks inherent in the CDS market, and thereby help[ing] to mitigate the potential systemic impacts.” The single counterparty could help prevent one market participant from destabilizing the entire market, as in the case of AIG. The central counterparty for the CDS market would act as the reliable backstop, a backstop that was not present in the previous CDS market.

Lastly, Congress should reenact the anti-bucket shop laws that it preempted with the CFMA of 2000. In doing so, the bucket shop transaction should be eliminated from the CDS market altogether, for it is here where the true evil lies. The gambling on the market brought it down, and should be prevented from ever happening again. To prevent further bucket shop transactions, the regulatory agencies overseeing the CDS market must make sure that those who purchase CDSs are doing so for the purpose of reallocating the credit risk of an asset they actually own. There can be no more empty transactions or pure speculation eroding the economy from within. When bucket shops were banned after the Panic of 1907, the legitimate markets were boosted with an influx of investors. A ban on CDS bucket shop transactions will ensure that the resources in this fifty to sixty trillion dollar market can be used to strengthen our economy and not simply bet on its overall success or failure. With regulations in place, a stable economic recovery will be secured and progress will be made in preventing a similar economic collapse.

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202 Testimony, supra note 200; Cho & Goldfarb, supra note 196; Cox, supra note 199; Financial Markets in Crisis, supra note 124.
203 Cox, supra note 199.
204 Financial Markets in Crisis, supra note 124.
205 Cho & Goldfarb, supra note 196.
206 Testimony, supra note 200.
V. CONCLUSION

The economic crisis in which we find ourselves is an excellent example of how difficult it may be to see what could be wrong when everything seems to be going so right. That is why we must never forget the lessons history has taught us and hope that it acts as an ever present reminder of the consequences of our behavior. When the CDS shadow market was freed from regulations, one needed only to look to the past to see our impending future. As soon as the “this time it will be different” mentality seeped into our society, a door to the dangers of our past opened. In our present case, gambling on Wall Street reemerged with the same devastating effects as it once had.

The public sentiment has now turned towards regulation, as people watch our economy spiraling down, but it will quickly be forgotten once the economy begins its upward climb. That is why the regulations we enact and enforce today are crucial in protecting us as we move forward, undoubtedly forgetting their origins as years pass. The regulations and laws which we put in place protect us not only from present dangers, but from those of the past as we move into the future.

We must not allow our economy to be seduced and led astray by the newest financial instrument touting itself as a risk free investment, an instrument which can make millions without any work or effort on the part of the purchaser. This time Wall Street bought into the CDS, and other similar, equally reckless instruments will assuredly emerge as our economy recovers. Armed with the lessons from the past, we must be willing to resist the temptations these new financial instruments may bring, and continue to promote stable and sustainable economic growth, growth that ensures the prosperity of America as a whole.