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THE CHALLENGE OF DERIVATIVES (CONTINUED)

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IN 1986, the National Association of Securities Dealers ("NASD"), concerned about the claimed effect of something called concentrated short selling (just as it is today with small order execution system ("SOES") trading), conducted a study of the subject.[1] The Executive Summary[2] to that study, since it was written, has summed up for me all that is wrong with the regulatory approach to business problems. Among other benefits of short selling the study found:

> "[S]hort selling . . . [provides] day-to-day . . . liquidity to the market."[3]
>
> "Selling short enables market participants to adjust their portfolio and risk positions in many circumstances."[4]
>
> "[Short sales cause] stock prices to be more responsive to new information and developments . . . moderating wide swings in stock prices."[5]
>
> "[T]ick restrictions that broadly impact all short-selling activities may be of questionable utility."[6]

And having reviewed the supposed worst cases of short selling "abuse," the study found that "a valid basis existed for short selling in most of the selected securities."[7]

You will have guessed that after the study, the NASD adopted, and the Securities Exchange Commission ("SEC") approved, regulations to limit short selling in the over-the-counter ("OTC") market, including a tick-test.[8]

Without spending more time on this, the point I would make is that regulation is driven by more constituencies than the business parties involved in the transactions at issue, and those special interests flaw regulation both in its conception and enforcement. Thus, when I last spoke on derivatives at Fordham Law School in the fall of 1994, the

1. National Association of Securities Dealers, Inc., Short-Sale Regulation of NASDAQ Securities (1986). Those pressing for short sale regulation were speculative over-the-counter ("OTC") issuers claiming that the securities of their companies were (as noted in the report) the "targets of professional short sellers." *Id.* at 101. The opposing parties were short sellers and market makers.
2. National Association of Securities Dealers, Inc., Short-Sale Regulation of NASDAQ Securities Executive Summary (1986).
3. *Id.* at 3.
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.* at 8.
8. National Association of Securities Dealers Manual Rule 3350 (1997).

challenge of derivatives which I saw was to this sort of regulatory extravagance.[9]

It should be recalled that at that time the investing world was reeling from highly publicized recent losses in, among other excitements, the Procter & Gamble,[10] Gibson Greetings,[11] and Askin Capital Management[12] matters, with Barings,[13] Orange County,[14] and Metallgesellschaft[15] yet to come. And it should also be recalled that the regulatory voices were predictable and loud. SEC Chairman Levitt predicted that a derivative-driven "accident" would lead to the failure of a large firm resulting in effects throughout the market. Representative Leach pronounced that "[a] commonality of standards [to control the risks of derivatives] cannot be achieved without legislation."[16] And legislation was introduced into Congress in 1995 and after, including the Risk Management Improvement and Derivatives Oversight Act of 1995, which would have created a Federal Derivatives Commission.[17]

That no broad regulation was enacted is not, I believe, due to the voices of economists and other experts who were quickly able to ascertain that the debacles cited above did not derive from some intrinsic evil of derivatives, but rather from managerial inadequacies. After all, as I noted, economic analysis and reality did not stop the advent of short sale regulation. Neither is the lack of broad regulation because ultimately everyone, including regulators and legislators, understood that the use of derivatives were simply crucial to the operation of

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9. The talk led to my article, *The Challenge of Derivatives*, 63 Fordham L. Rev. 1993 (1995), which treats the onset of concerns about derivatives.

10. Procter & Gamble reported in 1994 that it had lost $157 million in interest rate and deutsch mark swaps with Bankers Trust Securities Co. Litigation between the two companies was eventually settled. *See also infra* note 39.

11. Gibson Greetings lost $23 million in 1994 in derivatives transactions with Bankers Trust. It is believed to be the first American corporation to sue on OTC derivatives losses. The case was settled in November 1994 with Bankers Trust accepting two-thirds of the loss. *See* John Connor & G. Bruce Knecht, *Bankers Trust Facing Action on Derivatives*, Wall St. J., Dec. 5, 1994, at A3. The matter also resulted in SEC, Commodity Futures Trading Commission ("CFTC"), and Federal Reserve investigations. *See infra* note 35.

12. Askin Capital Management, a hedge fund managing $2 billion, speculated in collateralized mortgage obligations ("CMOs") and became the first of the 1994 derivative-related hedge fund collapses. *See* Floyd Norris, *A Speculator Collapses*, N.Y. Times, Apr. 3, 1994, § 3, at 1.

13. The Barings, PLC matter was extensively reported by the press in February-March 1995. See Saul Hansell, *The Collapse of Barings*, N.Y. Times, Feb. 28, 1995, at D1; *see also infra* note 38.

14. The Orange County, California disaster is not completely resolved. Suits against its underwriters and others continue.

15. *In re* MG Refining and Marketing Inc., CFTC Docket No. 95-14 (July 27, 1995), *available in* 1995 WL 447455 (C.F.T.C.). *See also infra* note 36 and accompanying text.

16. *Oversight of Derivatives Moving at Acceptable Pace, Fed's Phillips Says*, 26 Sec. Reg. & L. Rep. 1313, 1315 (1994).

17. H.R. 20, 104th Cong. (1995).

multi-national enterprises. Instead, the absence of broad regulation is attributable to the prosaic facts that Barings died and (just as Drexel Burnham) affected no one—except its owners and employees—and that by June of 1995 interest rates had fallen and many speculative derivative contracts entered into by institutions—such as Midwestern State University and the State of Texas Investment Fund, important members of the sorts of constituencies that drive Congress—profitably matured.[18]

Thus, the legislation before Congress today is at the margins: an expanded Treasury amendment to include equity swaps among transactions exempted from regulation,[19] an effort by the banks to overturn the Financial Accounting Standards Board's ("FASB's") draft standards of Accounting for Derivative Instruments and for Hedging Activities,[20] and the ever popular, and never enacted, repeal of Glass-Steagall,[21] to include derivatives sales practice regulation by the SEC while the actual transactions remain on the books of banks. (As I write this, I understand from a knowledgeable legislative source, that none of the above—or the re-do of the Commodities Exchange Act ("CEA") and the creation of professional markets for various futures—will be enacted in this legislative session, if ever.) But though I have described these proposals as marginal, two do carry, and are understood to carry, what I see as the challenge of derivatives to regulation more openly than we have seen before: equity swaps and professional markets. I would argue that these, posing the question—regulation or no regulation in all or none terms—are as subversive to regulation as the anarchic, democratic, information driven internet.[22] Thus, this talk seeks to explain—other than that matters have quieted down—why broad based regulation of derivatives has not only failed to be enacted, but rather why the pressures are toward exemptions or exclusions of derivatives and markets from regulation, exactly at the other end of the scale.[23]

18. *See* Jeff D. Opdyke, *Derivatives Crisis Fades as Rates Fall*, Wall St. J. (Texas), June 7, 1995, at T3, *available in* 1995 WL-WSJ 872890.

19. *See Equity Swaps by Banks Win Legislative Approval*, Wall St. Letter, June 23, 1997, at 7 (discussing Campbell amendment). The SEC was reported to be seeking to have the legislation "exclude" rather than "exempt" equity swaps. *See Aide Outlines Critical Decisions in Lugar Bill*, Wall St. Letter, June 23, 1997, at 7.

20. Financial Accounting Standards Board, Accounting for Derivative Instruments and for Hedging Activities, Sept. 12, 1997 (visited Nov. 23, 1997) <http://www.fasb.org.>; *see* Reed Abelson, *Accounting Board Proposal on Derivatives is Getting Heat*, N.Y. Times, Sept. 2, 1997, at D1.

21. The House Commerce Committee bill addressing Glass-Steagall repeal was placed on the Committee web site <http://www.house.gov/commerce> on Sept. 16, 1997.

22. The exponential expansion of access to the internet has raised questions as to the efficacy of securities regulation regarding corporate information, issuance of securities, execution of transactions, communications with customers, and fraud.

23. The authorization of largely unregulated professional commodities markets is part of congressional consideration of the deregulation of the futures industry. *See*

Perhaps the place to start is with risk. Transactions in derivatives are bathed in risks generally unknown to trading in ordinary stocks and bonds. Aside from the theoretical risk to the system referred to above, these risks range from simple lack of understanding of the cost, efficacy, and loss potential of the product being employed, through the legal risk of lack of enforceability to economic risks tied to early termination of the contract.[24] The response to control of all such risks except legality is, in narrow terms, intellectual skill or expertise and in broad terms indirect regulation—activity and examination guidelines, risk management, and adequacy of internal controls—and voluntary dealer compliance, for example, the Derivatives Policy Group principles.[25] Since we are at a law school I should spend a minute on legality.

There are myriad potential legal theories available to the party to a derivatives contract, normally the end-user rather than the dealer, who seeks to avoid the effect of its agreement. Legal theories pressed by plaintiffs include such common law causes of action or defenses as: breach of fiduciary duty, ultra vires, inability to contract or lack of meeting of the minds, fraud, reckless and negligent misrepresentation and concealment, to reliance on statute and regulation, for example, violations of not only such headline laws as the Federal Securities Acts and the Commodity Exchange Act, but the more obscure state blue sky laws, and the still more obscure state deceptive trade practices laws and gambling laws.[26] In one commentator's imagination, there are defenses in the implied warranty of fitness found in the Uniform Commercial Code, suitability theories under the rules of the various self-regulatory organizations, and even the anti-trust laws, which contain the concept of illegal tie-in sales of one financial product with another.[27] And, of course, if all else fails, there is always RICO.

As one survey has put it: "The development of legal principles in derivative litigation is in its infancy. . . . For now, the options [presumably the authors intended no pun] of defrauded or misled purchasers are limited only by the facts and the creativity of counsel."[28] Given the parties who engage in derivatives contracts—the Minmetals[29] and

Richard R. Lindsey, SEC Director of Market Regulation Division, Speaks to Derivatives, Derivatives, July/Aug. 1997, at 284.

24. The risks are set out in my article, *supra* note 9, at 2010-13.

25. Derivatives Policy Group, Framework for Voluntary Oversight (1995).

26. *See* L. Clifford Craig et al., *Legal Theories in Lawsuits Against Derivatives Dealers in the Over-the-Counter Markets*, 931 PLI/Corp 129 (1996).

27. Denis M. Forster, *Derivative Litigation: An Overview—End-Users and Dealers Liability Theories and Tactical Considerations*, 931 PLI/Corp. 9 (1996).

28. Craig et al., *supra* note 26, at 175.

29. Lehman Bros. Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., No. 94 Civ. 8301 (JFK), 1996 WL 346426 (S.D.N.Y. June 25, 1996).

Rayapratama[30] cases being two examples—I would put quotations around "defrauded" and "misled."

I have mounted this exhibition of legal theory miscellany to note that it is but one of an array of control devices, strategies, and narrowly based government enforcement actions which have taken the place of broad-based regulation. If you imagine bullet points:

> •Since Orange County, Texas has required dealers to sign letters that their transactions with municipalities will preclude imprudent investment activities by these local authorities. Sort of a penny stock approach to derivative transactions.[31]
>
> ◦The already mentioned guidelines, Framework for Voluntary Oversight,[32] created by six major dealers in coordination with the New York Fed and various trade associations, is subject to continued criticism by the U.S. General Accounting Office and others, that it has no teeth, is voluntary, and leaves many loose ends.[33]
>
> •SEC consents such as this month's Mitchell Hutchins Asset Management matter,[34] in which an advisor was disciplined for what appears to be a combination of losses by a government securities mutual fund resulting from a class of derivatives which comprised three percent of assets and the use of the common legal phrasing that the fund had "no present intention" of investing in such derivatives; or to go back two years, Gibson Greetings, which despite its well-publicized injuries suffered in its Bankers Trust transactions, was disciplined together with its CFO and Treasurer for failing to report on Gibson's 10-Qs that what was intended to be an interest rate hedge "amounted to trading or speculation," for accounting purposes.[35]
>
> ◦(If I may be permitted an aside at this point, the Metallgesellschaft case illustrates something that the public does not know and that most practitioners have let slip to the back of their minds: That is, consent agreements have no probative value either in civil or disciplinary matters. As the case noted: "[A] consent decree is not a 'true adjudication of the underlying issues.'")[36]

30. P.T. Adimitra Rayapratama v. Bankers Trust Co., No. 95 Civ. 0786 (JSM), 1995 WL 495634 (S.D.N.Y. Aug. 21, 1995).

31. Texas appears to be a lonely pioneer of this approach. *See* Tex. Gov't Code Ann § 2256.005 (k)-(l) (West Pamphlet 1998). The failings of similar penny stock letters have recently been described. *See La Jolla Capital Barred from Sale of Penny Stocks*, Wall St. J., Sept. 12, 1997, at B9D.

32. *See supra* note 25

33. *See* U.S. General Accounting Office, Financial Derivatives: Actions Taken or Proposed Since May, 1994 (1996).

34. *In re* Mitchell Hutchins Asset Management, Inc., Investment Advisers Act Release No. 1654, 65 SEC Docket 653 (Sept. 2, 1997), *available in* 1997 WL 537042 (S.E.C.).

35. *In re* Gibson Greetings, Inc., Exchange Act Release No. 34-36357, 60 SEC Docket 1401 (Oct. 11, 1995).

36. *In re* MG Refining & Marketing, Inc. Litigation, 94 Civ. 2512 (S.D.N.Y.), Comm. Fut. L. Rep. (CCH) ¶ 26,956, at 44,634 (Jan. 22, 1997).

•The need to avoid net capital rules applied by the SEC to broker-dealers, thus twisting dealer corporate structures out of all recognizable shape and, among other things, resulting in the Securities Industry Association's ("SIA's") pressing of the concept of limited purpose broker-dealers upon the SEC to accommodate this need.[37]

•The open-ended liability caused by hindsight analysis of what comprises management understanding of and internal guidelines to control a sometimes complex product, as often set forth in the sort of generalities in the House of Commons 1995 report on the Barings disaster.[38]

•Issues of fiduciary obligations of dealers with advised counter-parties, if not in suitability terms as illustrated by the federal court decision in Bankers Trust and Procter & Gamble, then in the sort of ethical effect on public relations that large institutions, dependent on public good will, cannot resist; not to mention the negative effect on the careers of senior management.[39]

•The potpourri of less than fully convincing approaches to measurement of risk as part of risk management, such as sensitivity testing, marking to market, value at risk[40] (to compute which there are itself various methods), etc.

•And, of course, the overall concern that whatever exemptions or exclusions from regulation of these contracts exist—if, in fact, there are such things—will be snatched back in a regulatory minute if a compelling enough situation comes along.[41]

Contemplating these examples, and especially if you are someone who waited breathlessly two weeks ago this evening at the FASB web site to be the first on your block to print out 135 pages of draft standards and examples, you might say "I don't want to be pecked to death by

37. Since broker-dealers that engage in derivatives transactions are subject to SEC net capital rules (requiring a 100% "haircut" for swaps), firms engage in such transactions through unregistered affiliates. Such affiliates raise supervision, corporate management, and enterprise liability issues. The Securities Industry Association ("SIA") in 1993 took a position supporting a less strict net capital rule. SIA now proposes the creation of limited purpose registered broker-dealers (for example, dealers in OTC derivatives) which would preserve regulatory oversight while relaxing net capital rules.

38. Board of Banking Supervision, Inquiry into the Circumstances of the Collapse of Barings 250 (1995).

39. These considerations drive consent decrees. Soon after the Procter & Gamble, Gibson Greetings, and Air Products & Chemicals settlements, the Chairman of Bankers Trust Co. retired. *See also* John M. Quitmeyer, *Fiduciary Obligations in the Derivatives Marketplace*, Secs. & Commods. Reg., Oct. 25, 1995, at 179.

40. *See* Kenneth S. Leong, *Value-at-Risk in a Nutshell*, Derivatives, July/August 1996, at 272.

41. The CFTC action in Metallgesellschaft, *supra* note 15, is an obvious example. Under Congressional pressure the then Chairperson of the CFTC was forced to say that "[t]he MG settlement had nothing to do with swaps," but rather that the enforcement case "was a response to a serious failure of MG's internal controls." Joanne Morrison, *CFTC Promises Not to Regulate Swaps Like Futures*, Bond Buyer, Jan. 23, 1996, at 6.

ducks," and might then well ask: What is wrong with a single source of all encompassing derivatives regulation?

A flip reply might be that subversion is more fun, but I would think that by now the evidence is convincing that broad-based regulation simply does not fit a subject as protean as derivatives. Even the director of the SEC's Division of Market Regulation recently noted that the SEC did not see a need for additional regulation in this area.[42] Thus, it is likely that items from the menu of legal horrors I have provided, along with attempts to encourage, through enforcement proceedings, stronger management controls and other regulatory guerrilla activities, will constitute whatever derivatives regulation we are likely to see.

In fact, the movement appears to be away from regulation: Not only have position limits been raised on the S&P indices, but position limits were eliminated entirely last week on flex equity options.[43] Since these "E-Flex options" are largely an institutional product (the position limit had been 75,000 contracts or 7,500,000 shares), their elimination makes a telling argument for the creation of exchange institutional markets, being put forward by the various non-equity exchanges and the Federal Reserve Board.

Think about the challenges such a professional financial futures market poses to regulation. Since the definition of institution encompasses entities with as little as $1 million of net worth and individuals with assets above $10 million, this market would have 90% of the volume and thus its quotes would lead the now shrunken, shall we say, "amateur" market.[44] (By the way, this type of market is hardly a far-fetched concept: compare Instinet to Nasdaq.)[45] The market would have no position limits or trade reporting. Its dealers would have no suitability concerns. The question would then be: Why should the exchange, as a self-regulator, be responsible for retail customer sales practice regulation, made increasingly expensive without the subsidization of business from institutions?

In equal measure, the humble plain vanilla equity swap also poses great challenges to regulation. The swap offers, in effect, 100% mar-

42. *Supra* note 23, at 287. Alan Greenspan, Chairman of the Federal Reserve was reported to have said that regulation of off-exchange transactions between institutions, as mandated by the CEA, is "wholly unnecessary." . . . *As Swaps Dealers Boosted by Dunn Decision*, Wall St. Letter, Mar. 3, 1997, at 9.

43. *See* Robert McGough et al., *Money Managers' Notice Board*, Wall St. J. Eur., Sept. 12, 1997, *available in* 1997 WL-WSJE 12211604.

44. The estimates appear in the Lindsey interview. *Supra* note 23, at 287.

45. Trades on Instinet, the leading electronic communications network, represent a substantial portion of the Nasdaq market securities volume. The SEC order handling rules adopted in 1996 address this issue in part, and a recent SEC concept release seeks advice on rationalizing the roles of electronic communications networks ("ECNs") and exchanges. *See* Regulation of Exchanges, Exchange Act Release No. 38,672, Fed. Sec. L. Rep. (CCH) ¶ 85,942, at 89,630 (May 23, 1997), 62 Fed. Reg. 30485 (June 4, 1997).

gin; so much for the vestigial margin rules. It can be tailored to control large amounts of a security, raising challenges to position limits and other restrictive rules. And again, it is largely an institutional product, conferring benefits on one class of investors, simply not available to others.

To sum up: Derivatives pose today's great challenge to the financial regulation we accept as immutable. They are the cause of the creak one hears in the decades old structure of federal securities, commodities, and banking regulation. Since the derivative is a commercial necessity, regulators are pressed to limit regulation; broad-based or centralized regulation of derivatives is therefore unlikely. On the other hand, a foreseeable consequence of the acceptance of a different regulatory regime for derivatives is the narrowing or even elimination of heretofore important aspects of the regulation of markets and products.