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## Risk Management and the Rogue Trader: Trading-Related Losses, Director & Officer Liability, Prudent Risk Management, Insurance Risk Transfer, the Role of Education

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## LECTURES

### INTERNATIONAL SYMPOSIUM ON DERIVATIVES AND RISK MANAGEMENT

#### RISK MANAGEMENT AND THE “ROGUE” TRADER: TRADING-RELATED LOSSES, DIRECTOR & OFFICER LIABILITY, PRUDENT RISK MANAGEMENT, INSURANCE RISK TRANSFER, THE ROLE OF EDUCATION

*Jeffrey S. Grange\**

In my presentation I would like to follow on some of the themes that Superintendent Levin addressed,<sup>1</sup> particularly the importance of education, internal controls, and corporate governance as part of risk management when dealing with directors' and officers' liability.

My purpose is two-fold. First, I will outline the risks to directors and officers arising out of capital markets trading in derivative instruments and other financial products. Second, I will discuss what practical steps can be taken to reduce these risks.

In order to accomplish these objectives, I will focus my remarks in three ways: (1) risk identification, where I will identify the sources of directors' and officers' liability; (2) risk management, where I will outline the various risk management strategies that reduce risk; and (3) risk transfer, where I will discuss how insurance can be used as a means to transfer directors' and officers' liability risk to a third party and to mitigate a director's exposure to loss.

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\* Vice President, Chubb & Son. Jeffrey S. Grange delivered this speech at Fordham University School of Law on February 25, 2000, as part of the Fordham Institute on Law and Financial Services International Symposium on Derivatives and Risk Management. This is the second in a series of speeches given at the Symposium published in the *Fordham Law Review*.

1. See Neil D. Levin, *Insurance Supervision Meets the Marketplace: The Regulatory Response to Derivatives as a Risk Management Tool in the Insurance Industry*, 69 *Fordham L. Rev.* 17, 21-24 (2000).

## I. RISK IDENTIFICATION

As I think we are all aware, the headlines are replete with stories of financial mismanagement, rogue traders, and huge losses associated with capital markets trading.<sup>2</sup> In the wake of volatile financial markets, a number of corporate end-users, municipalities, hedge funds, and financial institutions have disclosed multibillion-dollar losses.<sup>3</sup> Often, the response to these losses has been a series of derivative-related lawsuits from stakeholders.<sup>4</sup> These include shareholders, regulators, mutual fund unit holders, customers, and various counterparties. Derivative-related losses heighten the awareness of directors, senior managers, regulators, customers, and shareholders to the potential risks associated with capital market trading activity and inefficient risk management processes.

Companies utilize capital markets and derivatives as part of a comprehensive program of managing market, credit, and financial risk. They also use proprietary trading as a means of achieving profit. Experience shows that the majority of trading losses involve some combination of the following risk factors: breach of authority limits, trading outside of permitted products, trading with unapproved counterparties, insufficient disclosure to end-users, lack of suitability, management's failure to supervise traders or dealers, failure to hedge, valuation or pricing risk due to model failure, breach of internal investment guidelines, excessive leverage, inadequate internal controls, and plain old-fashioned employee dishonesty or theft.<sup>5</sup>

Any one of these risk factors, coupled with a financial loss that damages a third party, can be a source of management liability. Trading losses in client accounts will cause customers to seek recovery for their economic losses. The damaged parties will typically allege

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2. For example, see Gerard Baker & Maggie Urry, *Daiwa's Road to Financial Disaster: Gerard Baker and Maggie Urry Explain the Extraordinary Events Behind the Losses at the Japanese Bank*, Financial Times (London), Sept. 30, 1995, at 7; John Gapper & Nicholas Denton, *Leeson's Bid to be a Star Led to Bank's Crash: Trader 'Subsidised' Sale of Derivatives*, Financial Times (London), Sept. 18, 1996, at 1; John Gapper & Christopher Parkes, *Top Banks Allege Big Frauds by Employees: Credit Lyonnais and Deutsche Bank Lose Millions*, Financial Times (London), Apr. 8, 1995, at 1; Rob Garver, *Operational Lapses Cost the Industry \$7 Billion*, American Banker, Nov. 18, 1999, at 1; Brian M. Sullivan, *Blame Lax Management, Not Derivatives*, American Banker, Mar. 31, 1995, at 18.

3. See Garver, *supra* note 2.

4. See Kevin Dietrich, *Small Banks Develop Taste for Some Derivatives Deals*, American Banker, May 29, 1996, at 8 (noting the "numerous lawsuits brought against derivative trading firms such as Bankers Trust"); Jim Kelly, *Barings Auditors Sued for £460M*, Financial Times (London), June 8, 1996, at 5; Joseph Radigan, *Playing Catch-up on Risk Control*, U.S. Banker, July 1996, at 32 (discussing the "flurry of lawsuits" that resulted from the failures of Kidder Peabody and Barings PLC and the trading losses by Daiwa Bank's New York branch).

5. See generally Robert C. Cox & Jeffrey S. Grange, *Risk Management Issues and the Rouge Trader*, Bank Director's 1999 White Paper on Risk Management (1999) (listing common risk factors to trading losses).

that the directors and officers breached their common law duty of care, failed to supervise their traders, that the derivative instruments or financial products were not suitable for the customer, or that there was a breach of contract.

Furthermore, where there are large proprietary losses that precipitate a drop in the value of publicly traded securities, directors and officers may be the target of derivative or class action lawsuits. Allegations may include improper or insufficient disclosure, breach of fiduciary duty, fraud, improper supervision of employees, violation of securities laws, breach of trust, or breach of investment guidelines. If the loss is substantial, these allegations may also invite investigation and legal action from regulatory authorities.

Public companies must adequately disclose their capital market trading activity. The federal securities laws require extensive disclosures about market exposure and risk, including quantitative disclosure, such as Value at Risk ("VAR"), duration, and sensitivity analysis.<sup>6</sup> In addition, banking regulations require a description of derivative market activities in regular call reports.<sup>7</sup> Material details concerning a market participant's transactions and positions must be included in these disclosures.

Generally, the Securities and Exchange Commission ("SEC") requires companies to disclose all material information. At the end of each reporting period, public companies must disclose the fair value of financial instruments, their potential effect on future earnings, and the cash flow implications of market-risk-sensitive instruments.<sup>8</sup> The accounting irregularities at several large public companies have focused the SEC's attention on accounting losses and the transparency of financial reporting. The SEC has announced its intention to provide a safe harbor for forward-looking descriptions of capital market trading activities, and this safe harbor is similar to the provisions of the Private Securities Litigation Reform Act of 1995.<sup>9</sup>

The inherent complexity of derivative products, the embedded assumptions built into derivative pricing models, and the volatility of market conditions are all factors that affect an investor's decision to purchase stock. Because many derivatives are currently carried off-balance sheet, and their impact on the financial health of the corporation is not readily apparent to the public, the Financial Accounting Standards Board ("FASB") has issued new rules

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6. See Securities Exchange Act of 1934, 15 U.S.C. § 78a (1994); Securities Act of 1933, 15 U.S.C. § 77a (1994); 17 C.F.R. § 229.301-303 (1999).

7. See Accounting for Derivative Instruments and Hedging Activities, Statement of Financial Accounting Standards No. 133, §§ 44-47 (Financial Accounting Standards Bd. 1999).

8. See 15 U.S.C. § 78m; 17 C.F.R. §§ 240.13a-1, 240.13a-13.

9. See 15 U.S.C. § 77z-2 (Supp. IV 1998).

regarding derivative reporting.<sup>10</sup> FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, establishes accounting and disclosure standards for derivative instruments.<sup>11</sup> The FASB has crafted rules for accounting for derivatives and hedge transactions in order to make the balance sheet more transparent to shareholders and investors.<sup>12</sup>

FASB Statement No. 133 will require public companies to evaluate their derivative exposures in preparing financial statements.<sup>13</sup> FASB Statement No. 133 is built on four cornerstones: (1) derivatives are assets and liabilities, and as such should be recognized in the financial statements;<sup>14</sup> (2) derivatives should be marked to market and not carried at historical cost;<sup>15</sup> (3) gains and losses on derivative transactions do not represent liabilities or assets and should not be depicted as such on the balance sheet;<sup>16</sup> (4) hedge accounting should be permitted in limited circumstances.<sup>17</sup> FASB Statement No. 133 requires that all derivatives be carried on the balance sheet at fair value.<sup>18</sup> Of course, from the viewpoint of directors and officers, FASB Statement No. 133 is a rather complex standard for recording derivative transactions in the public domain.

## II. RISK MANAGEMENT

Given the potential exposure to financial loss and legal liability, it is imperative that directors and officers implement a comprehensive policy of best practices with respect to operational risk management so as to mitigate their ultimate exposure to loss. Derivatives are, by definition, leverage. They may be relatively illiquid and, therefore, may pose unique risk to portfolio managers and corporate fiduciaries. Derivatives are neither good nor bad, but the process of ensuring that derivatives are used prudently is a major focus of operational risk management.<sup>19</sup>

Underpinning this notion of effective operational risk management is the concept of suitability.<sup>20</sup> When a derivative-related loss occurs, a counterparty may assert that the financial institution that structured

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10. See Accounting for Derivative Instruments and Hedging Activities, Statement of Financial Accounting Standards No. 133, *supra* note 7.

11. See *id.* §§ 1, 3.

12. See *id.* §§ 3, 220.

13. See *id.*

14. See *id.* §§ 3, 217-19.

15. See *id.* §§ 3, 220-23.

16. See *id.* §§ 3, 229.

17. See *id.* §§ 3, 230.

18. See *id.* §§ 3, 220-23.

19. See Levin, *supra* note 1, at 20-21.

20. See Risk and Derivatives Consulting Board, Inc., Market Volatility and the Rogue Trader: A Handbook for Directors, Officers, and Risk Managers 14 (2000) [hereinafter Handbook].

the transaction breached its duty of care by encouraging inappropriate financial investments. Banks and broker-dealers have a fiduciary obligation to find suitable investments for their clients. Similarly, fund managers are obligated to find investments that are consistent with stated market objectives and the guidelines that they disclose to investors, regulators, and unit holders.<sup>21</sup>

In the derivatives context, a bank is required to ascertain that a particular derivative transaction is suitable for its client. The extent of this obligation is relative to the sophistication of the counterparty. The “seller” or “designer” of the derivative is likely to be considered much more sophisticated than the “buyer” or “end-user” of that derivative. If unsuitable investments are created and sold to clients, directors and officers may be held liable for failing to prevent questionable sales practices.

Liability for a breach of fiduciary duty between a bank and its client flows from the common law, from the terms of the contract, or by virtue of statutory obligation. In the derivatives context, rules governing suitability depend substantially on self-regulatory organizations, such as the National Association of Securities Dealers and the New York Stock Exchange.<sup>22</sup>

Plaintiffs claiming that a financial institution breached a fiduciary duty must prove four elements to be successful: (1) the financial institution sold an investment to a customer; (2) the investment was unsuitable to the customer; (3) the financial institution recommended the investment knowing of, or in reckless disregard of, its unsuitability; and (4) the customer relied on the financial institution in making the decision to invest.<sup>23</sup>

Similarly, in the fund management context, investment advisors and fund directors may be held liable where they select unsuitable investments that lead to losses. Beneficiaries of a trust or unit holders of a mutual fund will claim that the trustees or investment advisors breached their fiduciary duty in not overseeing suitable investments of fund assets as determined by the fund’s investment guidelines. Operational risk management provides a means for investment fiduciaries to monitor the investments of assets that have been entrusted to them. By clearly defining risk tolerance, implementing monitoring techniques, and designing effective reporting structures, directors can reduce their potential liability. Operational risk management allows directors to oversee front-line traders and sales people.

A goal of operational risk management is to limit reputational risk. This can be accomplished by increasing managerial control over

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21. *See id.*

22. *See id.*

23. *See id.*

capital market trading activities. In our context, reputational risk is the risk that customers and shareholders will lose confidence in the firm's ability to manage its front-line traders and salespeople. Prudent management of firm-wide financial risks and capital market trading activities indicates a strong management and helps protect one of the firm's most valuable assets, its reputation.

In the context of financial institutions, a crisis in confidence can result in a run on the bank — or, as we heard from Superintendent Levin, a run on the insurance company.<sup>24</sup> For asset managers and financial advisors, a crisis can cause investors to “vote with their feet,” initiating a “flight to quality” where investors take their money to a financial institution they perceive as more secure or trustworthy. Public corporations run the risk of losing shareholders when a crisis occurs, and the headlines are replete with stories of stock prices collapsing when there is a perception of managerial weakness.

Sources of reputational loss can be customer lawsuits, negative headlines, financial mismanagement, rogue trading, erosion of the firm's capital base, regulatory investigations, or excessive trading losses. It is difficult to measure, in dollar terms, the effects of a loss of reputation. A hint of derivatives-related loss can affect share price and market confidence in a firm's management team. Reputational loss is frequently a subset of perceived breakdown or operational failure. Directors need to know what is being done to manage enterprise-wide risk, and directors are obligated by their fiduciary duty to know and understand the risks that their enterprise is taking. By implementing a program of sound operational risk management, directors can begin to reduce their personal liability and mitigate enterprise-wide risk.

We think that one of the key aspects of effective risk management and loss prevention is education. In order to assist directors and officers, we have assembled a list of operational risk management questions. These questions form the basis of the information that directors need to know in formulating operating risk management strategies. The questions represent five areas of concern. These are: risk policies, oversight, reporting structures, information, and education.<sup>25</sup> The answers to these questions can help directors determine what risks they need to address in structuring a successful program of operational risk management.

In formulating policies and overseeing trading activities, the board's primary responsibility is to understand the needs of the enterprise and the risks involved in the firm's trading activities. The answers to these questions can be a good starting point for addressing firm-wide risk. These answers will form the information base that directors can use as

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24. See Levin, *supra* note 1, at 27.

25. See Handbook, *supra* note 20, at 17-18.

a springboard to formulate policies and procedures to manage operational risk.

Effective operational risk management requires designing reporting lines and audit techniques to help the board maintain control over trading activities, sales practices, and liquidity. The goal of operational risk management is to put in place procedures that prevent anyone from exceeding the board's mandate for acceptable risk.

The board can generally accomplish this by drafting a risk policy statement. The risk policy should describe in a qualitative and quantitative manner the board's risk tolerance level, require employees to abide by a code of conduct, require qualitative reports on a regular basis, design reporting structures and compensation incentives that are consistent with the board's risk policy, and empower certain directors to share primary responsibility for setting risk management policy and overseeing firm-wide compliance with the board's risk policy.<sup>26</sup>

Boards should consider establishing a Risk Management Committee whose specific charge is the active management of risk on an enterprise-wide basis. The Risk Management Committee will provide the board with a forum for open discussion about risk issues and risk policy. This committee will work with other board and senior management committees such as the Market Risk Committee and the Credit Risk Committee, to develop a holistic approach to managing risks associated with a portfolio of derivatives and financial instruments. The Risk Management Committee of the board will have primary responsibility for adopting standards and procedures for dealing with specific risk management tasks.

An alternative to establishing a stand alone Risk Management Committee at the board level is to charge the Finance Committee or the Audit Committee of the board of directors with the risk management function. Since a comprehensive approach to managing risk requires multiple risk disciplines, businesses, and support units, the Finance Committee may be the most appropriate committee for handling enterprise-wide risk management.

The committee that reports to the board on risk should have an agenda that addresses credit exposure, significant financial commitments, capital adequacy, new opportunities, implementation of enterprise policies, any risk management issues, and education.

The Audit Committee of the board will bear primary responsibility for ensuring that the board's risk policies are implemented and adhered to consistently across the organization.<sup>27</sup> Critically important to managing operational risk throughout the enterprise is that

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26. *See id.* at 20.

27. *See id.* at 21.



management information systems create transparencies that allow managers to monitor all corporate trading activities. These information systems must capture all trades and, most importantly, include new products. Because of the high-speed nature of financial innovation, there may be some lag time before tracking systems are able to monitor new products. Many of you who work in the financial services sector will realize that there are new financial products that are accounted for and captured on the traders' laptops but do not appear in the overall management information system of your enterprise. The board should be aware of this technology limitation and might require a daily exception report for new products.<sup>28</sup>

The primary goals of management information systems are: (1) to prevent traders from concealing trades; (2) to prevent traders from falsely recording trades; (3) to prevent traders from intentionally manipulating pricing data and pricing models; and (4) to track and monitor on a daily exception basis any violations by traders of delegated authority levels.

The risk policy should be a comprehensive summary of the will of the board with regard to capital market trading activities and risk management. It will describe, among other things, acceptable investments, position limits, procedures, reporting structures, credit and liquidity rules, and settlement guidelines.

There are several categories of risk that the board should address in the risk policy statement. These risks include, but are not limited to, operational, financial, credit, legal, liquidity, settlement, and in the commodities sector, delivery risk.

In the operational risk management context, the key to a successful reporting structure is the complete segregation of duties from the front and back offices. Traders must be prevented from having access to systems that allow them to manipulate trading information, pricing data, and pricing models.

The ideal framework or organizational structure for overseeing capital market activities involves three distinct operating groups—the front office, the back office, and of course, compliance. Importantly, each operating group should report independently.<sup>29</sup> Often, we see structures where compliance is actually reporting through the business unit. We suggest that independent risk management and compliance report directly up through the Audit Committee of the board and be segregated from the business function.

Each of these operating groups should report independently. The information collected from these groups will form the contents of the board reports and a “chief risk officer” will prepare and present this

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28. *See id.*

29. *See id.* at 23.

information to the appropriate board members.<sup>30</sup> These independent groups should be present at all locations where derivatives and/or financial products are traded. This is an important point. Clearly, some of the most notorious or infamous derivative trading disasters have occurred at remote locations far removed from the principal trading location, or home office, so to speak. That is typically where you have the audit, compliance, and independent risk management functions headquartered. The problem, of course, is that if you do not have those functions in the remote locations, it is impossible to use technology to monitor these positions remotely, a major weakness we have observed.

While the Internet and technology have made management information systems a vital tool of effective operational risk management, it is difficult, at best, as I have said, to manage trading risk from remote locations far removed from the principal trading location. The risk to the enterprise from financial products representing huge notional values, which may, overnight, become illiquid or impossible to hedge, must be monitored constantly by the board and its risk managers. Directors may need to require reports on a daily, and, if the notional values are large enough, perhaps even on an hourly, basis.

Because derivatives are so highly leveraged and relatively illiquid, they can jeopardize the financial stability of the enterprise. Directors must be kept informed, on a real-time basis, if a position threatens the enterprise. Because of the time-sensitive nature of derivatives trading, the flow of information is critical for directors and officers.

Information needs to be summarized for the board in a timely and consistent manner. The board should require frequent updates and reports on how risk policies are being implemented throughout the enterprise. In so doing, the board can better insulate itself and the enterprise from shareholder liability when trading losses affect the financial health of the enterprise. The primary goal of operational risk management is to manage the enterprise's trading, position taking, credit extension, and operational activities in a timely manner. Holistic risk management involves setting the strategic direction of the enterprise and setting the company's risk tolerance levels for each of these classes of risk.<sup>31</sup>

The production of board reports should not preclude any ad hoc information flow or inquiry up to the board. When a position is large enough to have a material effect on the enterprise, the board should be provided with real-time information in a consistent manner. Generally, board reports should include the following items and information written in plain English: (1) a list of current positions; (2)

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30. *See id.*

31. *See id.* at 25.

a description of the economic effects of current positions, including specific names of traders and market performance; (3) an explanation of how a particular market headline will affect the enterprise; (4) marked-to-market valuations of current positions; and (5) an explanation of any exceptions, limit breaches, or violations of risk tolerance policies.<sup>32</sup>

In analyzing these reports, the board should look for unusual trading activities identified by the firm's senior risk managers. Unusual trading activities include large profits.<sup>33</sup> People rarely look at large profits as being indicative of unusual trading. Yet, in some extreme cases it may be an indication that something is wrong. Take for example the Kidder losses. How one could ever make that much money trading strips is beyond me, and obviously it was beyond the pale for the management at Kidder.<sup>34</sup> The same was true in the Barings Futures case.<sup>35</sup> In Barings, senior management never inquired as to why twenty percent of the profits of the entire Barings Group was generated by a branch arbitrage trading operation.<sup>36</sup> Therefore, large profits, or huge swings in profits, should immediately focus the attention of the board and senior management.

In addition, there are inherent risks to directors when a firm's large variable or bonus compensation schemes are structured such that they provide incentive for traders to value profits above all other goals. This is very common, of course, in the investment banking community. Firm-wide compensation should be based on furthering the board's goals and not exclusively on a trader's profitability. Where trading serves as a firm profit center, compensation is often directly linked to a trader's success or failure. This direct link needs to be tempered by the board's risk appetite to discourage unethical behavior.

A means of achieving a balance between the risk policy and trading activities is to adjust compensation formulas to reflect the risk taken to achieve a particular result, and this risk-adjusted approach will help deter traders from taking overly risky positions. In general, enterprise-wide compensation should be flexible and should be based on contribution to the overall profitability of the firm and on efforts to work within the risk parameters set by the board.<sup>37</sup>

Most importantly, the conduct of an enterprise and its employees cannot rise above the level of the integrity of the managers and the leaders of that enterprise. Compensation policy is only one means of achieving ethical behavior in capital market trading activities. The

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32. *See id.* at 26.

33. *See id.* at 26-27.

34. *See Cox & Grange, supra* note 5.

35. *See id.*; Gapper & Denton, *supra* note 2; Kelly, *supra* note 4.

36. *See Cox & Grange, supra* note 5.

37. *See Handbook, supra* note 20, at 27.

key to a successful risk management program is a corporate culture that reflects the attitudes and dispositions of the board. The board of directors and senior managers set the tone for the culture of the institution. Management must convey the message of ethical values and integrity to the employees of the company. This issue cannot be compromised. Management has to demonstrate, through its actions and its communications, that it is committed to a highly ethical environment.<sup>38</sup>

The board should distribute, and employees should confirm receiving, a code of conduct describing enterprise risk policies. This code should describe an employee's responsibilities to the firm and to its shareholders. Employees should sign an acknowledgment that they will abide by the firm-wide risk policies. By anchoring risk policy in ethical goals, directors demonstrate business ethics that may be active throughout the firm. By creating a sense of high standards among the firm's employees, directors can feel more comfortable that they are being provided with timely, material, and accurate information.<sup>39</sup>

Ethical leadership encourages employees to support the board's efforts to manage operational risk. Employee-initiated communications are an important part of the risk management process. When the board creates a sense of integrity throughout the enterprise, employees will be more willing to provide ad hoc information about positions, events, and market risks. The information reflects what the staff feels the board should know and is offered without the board requesting it. A free flow of information to the board is the goal of ethics in operational risk management. It will generally happen when employees feel a sense of commitment to the board's values and risk policies.

The board should require all directors and officers to be informed of the company's risk exposures and the effects that adverse market and interest rate conditions will have on the company's financial risk profile. Directors may reduce their personal liability exposure by monitoring risk, seeking information, getting education, disclosing trading risk to shareholders, and seeking insurance to cover derivative-related losses.

Directors and officers can delegate their functional responsibility for risk management, but they can never delegate their ultimate legal liability.<sup>40</sup> Corporate fiduciaries can rely on experts, of course, and must become fully informed before they make important decisions. The business judgment rule protects a director when an informed business decision proves unsuccessful.<sup>41</sup>

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38. *See id.*

39. *See id.* at 28.

40. *See id.* at 32.

41. *See Brane v. Roth*, 590 N.E.2d 587, 591-92 (Ind. Ct. App. 1992) (stating that

A clear-cut information trail provides evidence that the directors and officers were informed when they rely on the advice of experts and senior managers. It is, therefore, vitally important to create a clear-cut reporting chain of materially relevant information from senior management to the board level.

Directors have an obligation to oversee corporate trading activities. Ignorance and absenteeism are not defenses that are available to directors and officers. Directors may rely on internal reports, outside opinions, and other sources of advice when making decisions, but they must be reasonably certain of their accuracy and validity before becoming entitled to rely on them.<sup>42</sup>

By requiring senior managers to prepare reports on derivative trading and risk-related activities, directors can fulfill their obligation to oversee corporate trading activities. Directors must be sufficiently knowledgeable about derivatives and risk management to appreciate their content. This reporting process helps prevent operational risk management failures that might lead to material trading losses.

Additionally, directors should take the important step of implementing a derivative and risk management education program for themselves and for enterprise risk managers. Education can help directors and officers understand the role that derivatives play in furthering enterprise goals. By demonstrating efforts to educate themselves, directors will enjoy the protection of the business judgment rule because their decisions will be presumed to be informed ones.<sup>43</sup> When companies disclose their derivative activities to shareholders, the public can be confident that the board has made risk management decisions on an informed and educated basis.<sup>44</sup>

### III. INSURANCE

Switching gears finally to insurance, directors can take all steps necessary to comply with disclosure requirements, make educated decisions, and reduce financial risk, and still not be entirely immune from liability arising from derivatives trading activity. Because operational risk management is subject to the vagaries of human nature, it is impossible to ensure that directors are liability-free, even after implementing the best practices of operational risk management.

There have been numerous lawsuits against mutual funds, banks, investment advisors, and securities brokers arising out of the misuse of

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"the business judgment rule protects directors from liability only if their decisions were informed ones"); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (finding no liability when "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

42. See *Brane*, 590 N.E.2d at 591-92.

43. See *Aronson*, 473 A.2d at 812.

44. See Handbook, *supra* note 20, at 34.

derivative products.<sup>45</sup> Failure to disclose the inherent risks of the derivatives, as well as the percentage of the invested assets in derivatives, have resulted in multimillion-dollar settlements, not to mention losses to the institution for uninsured or underinsured settlements.

Most of these cases involved elements of inadequate stress testing of the models, lack of or failure to enforce effective guidelines on the use of derivatives, and questionable sales practices. As part of the overall risk management plan, consideration should be given to procuring adequate insurance tailored to a firm's risk profile.<sup>46</sup> There are a number of insurance products available to directors and officers of the enterprise. I will briefly review four of the most relevant products available: professional liability; directors' and officers' liability, fidelity; or crime insurance; and a new product, called unauthorized or "rogue" trading.

#### A. Professional Liability

Errors and omission policies protect the directors and officers and the corporate entity against claims for wrongful acts in the performance or failure to perform professional services. Wrongful acts are generally defined as any act of error or omission, misstatement, or misleading statement. The definition of professional services varies based on the type of financial institution, but generally covers any service performed by the institution pursuant to an agreement for a fee. The coverage, of course, can be quite broad, depending on the range of services offered by the institution in question.

The professional liability product is broad. It includes all risk and provides third-party liability coverage. Underwriters are increasingly asked to provide coverage for trading losses. The typical policy has standard exclusions for fraud and dishonesty, and there are also exclusions for contractual liability and lender's liability. And, of course, this puts into question what coverage really exists. In order to provide coverage for the management liability arising out of trading losses, you need to work with your underwriters to have these standard types of exclusions removed. Directors should be aware that the direct financial losses of the institution arising out of trading solely on its own account, or proprietary trading, are typically not covered in a professional liability policy.<sup>47</sup> This deals with third-party claimants, or trades done in client order execution, as opposed to proprietary trading.

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45. See Dietrich, *supra* note 4; Radigan, *supra* note 4.

46. See Cox & Grange, *supra* note 5.

47. See Handbook, *supra* note 20, at 39.

Although professional liability policies provide very broad protection with respect to who and what is covered, not all of the allegations in a specific complaint may fall within insurance coverage. In addition to a self-insured retention or deductible, the insured may incur financial loss for uncovered matters.<sup>48</sup>

### B. *Directors' and Officers' Liability*

Directors' and officers' liability policies are designed to protect the individual directors and officers from liability arising out of claims for corporate mismanagement. The evolution of this product has expanded to provide coverage to the corporate entity for litigation arising out of securities laws violations, notably the SEC's 1933 and 1934 Acts, and Rule 10b-5 in particular.<sup>49</sup> As with professional liability policies, the coverage can be quite broad.

The largest and most frequent area of litigation for directors and officers are allegations of securities fraud, inadequate disclosure of material information, and insider trading. It is virtually certain that if there is a precipitous drop in the share price for any reason, the professional plaintiff bar will institute an action against the company. As mentioned earlier, derivative trading has been a major contributor to losses suffered by financial institutions, energy companies, manufacturers, and other public companies, both domestic and international.<sup>50</sup>

It is imperative that directors and officers, as a defense against potential litigation, stay actively involved in major business endeavors, as well as any unit that has the potential to cause severe financial disruption in the organization. Clearly, capital market trading has this potential. As we have seen many times, failure to supervise, disclose, and control derivative trading functions has led to economic loss. While there is no foolproof defense against being sued, a proactive compliance and reporting structure, effective and enforced procedures, and the use of outside experts to assess risk and verify methodology as part of firm-wide risk management, may provide strong defensive tools.<sup>51</sup>

### C. *Fidelity (Crime) Insurance*

Directors should be aware that trading losses are generally excluded from coverage under the Surety Association of America Standard Form 24 Financial Institution Bond, except when the dishonest or fraudulent act is committed with the intent to cause the insured to

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48. See *id.* at 40.

49. See Securities Exchange Act of 1934, 15 U.S.C. §78a (1994); Securities Act of 1933, 15 U.S.C. § 77a (1994); 17 C.F.R. § 240.10b-5 (1999).

50. See *supra* note 3 and accompanying text.

51. See Handbook, *supra* note 20, at 40.

sustain a loss and to obtain improper financial gain. Improper financial gain in this context does not include salary, commissions, fees, bonuses, promotions, or the like, that are otherwise earned in the normal course of employment.<sup>52</sup>

Trading loss experience suggests that in the beginning, most employees do not intend to cause a loss to the company. This was the case with the Barings and Daiwa Bank cases.<sup>53</sup> More often, the trades are errant decisions, or in some instances, moves made to cover up an original error. In other instances, their intent may be to increase the company's profits, or in fact to turbo their commission and bonus incomes. Therefore, not all unauthorized trades fall within the definition of employee dishonesty under the bond. Accordingly, your bond or your crime insurance, which you might quite naturally think would cover these types of scenarios, on closer scrutiny may very well not.<sup>54</sup>

Recently, fidelity or crime insurers have been asked to modify the dishonesty coverage under the bond. The definition of "improper financial gain" does not currently include remuneration earned during the normal course of employment. The dishonesty language, as I have said, states that two requirements must be met: (1) to cause the insured to sustain a loss; and (2) to obtain financial benefit.<sup>55</sup>

#### D. Unauthorized (Rogue) Trading

A new product that has emerged to fill this gap in coverage, the so-called unauthorized or "rogue" trading product. This policy provides coverage to the institution's proprietary losses arising out of capital market trading activities.

This new product deals specifically with the issue that traders may not be acting dishonestly, in the insurance context at least, to cause a loss or to obtain an improper financial gain. Yet, they are clearly acting beyond their designated authority. It precisely defines an "unauthorized trade" to include a trader who knowingly commits a limits breach of authority, trades with unapproved counterparties, or trades with unapproved products. Furthermore, the trader must either attempt to conceal his or her actions from management or falsely record trades in the books of account.<sup>56</sup>

In seeking to insure proprietary losses arising from unauthorized or rogue trading, the greatest challenge may be in the computation of ultimate loss. The computation of loss protocol would incorporate the

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52. See Cox & Grange, *supra* note 5.

53. See Baker & Urry, *supra* note 2; Gapper & Denton, *supra* note 2; Kelly, *supra* note 4.

54. See Cox & Grange, *supra* note 5.

55. See *id.*

56. See Handbook, *supra* note 20, at 41.



fundamental principle of insurance to indemnify the insured or to make him or her whole, as distinct from paper losses. This differs from the reimbursement of unrealized or reduced profits due to unauthorized trading. In insuring unauthorized trading losses, all profits should be netted against all losses. Presumably, the trader will not have exclusively all bad bets. There will be some that are winners.

Further, in those losses that commingle unauthorized trades with authorized trades, any profits received or collectible from the authorized trades should reduce the amount of unauthorized loss. This is complicated because many firms engage in risk management hedging across a portfolio. Therefore, it may be difficult to demonstrate a direct link between a series of unauthorized trades and the corresponding hedging transactions.<sup>57</sup>

### CONCLUSION

Directors and officers have a duty to participate fully in risk management. Where there is a breakdown of internal controls, directors and officers will be held accountable for operational failures contributing to trading losses. Education and real-time access to management information are the keys to loss prevention. I have outlined a framework for risk management's best practices with respect to capital market trading activities. In addition, directors and officers can turn to insurance risk transfer solutions to reduce their financial and legal liability risk with respect to trading activities to more acceptable levels.

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57. *See id.* at 42.