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International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commission

*by Brooksley Born**

Over the past decade, as derivatives markets – and particularly the over-the-counter (“OTC”) market – have become increasingly global in nature, the U.S. Commodity Futures Trading Commission (“CFTC”) – the federal regulatory agency that oversees futures and commodity option trading¹ – has played an active role in fostering international regulatory cooperation. The technology of the information age, allowing instant communication and electronic trading, has revolutionized financial markets, instituting around-the-clock, around-the-globe trading, globally active market users and market intermediaries, and an increasing pace of market innovation.

Market crises now have the potential for widespread financial impact and require international regulatory response. The 1997-1998 Asian financial crisis that caused equity and currency markets to tremble demonstrated more vividly than ever before that world markets are inextricably linked through related products and common market participants. Events that occur in one market can and frequently do cause global regulatory concerns. The shocks to the world financial system caused by several recent crises illustrate that this is true for derivatives markets as well as securities and currency markets.

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¹ Commodity Exchange Act, Section 2(a)(2)(A), 7 U.S.C. § 4a(a)(2)(A).

The CFTC has taken a leading role in encouraging international cooperation to address the issues of systemic risk posed by linked markets and global market participation and in facilitating worldwide adoption of higher regulatory standards. This article focuses on these international activities of the CFTC in the past decade and particularly on its reactions to three international derivatives crises occurring in the mid-to-late 1990s – the Barings Plc. failure in 1995, Sumitomo Corporation's manipulation of the copper markets in 1995 and 1996, and the collapse of Long-Term Capital Management L.P. in 1998. The article describes the CFTC's response to those crises and particularly the CFTC's efforts to work with foreign regulators to fashion international protections against the harmful widespread repercussions that such crises may have. The resulting international actions have contributed significantly to the effectiveness of regulation of the global derivatives markets and have laid the foundation for higher levels of international regulatory cooperation and harmonization in the future.

I. THE GLOBAL DERIVATIVES MARKETS

During the past decade, the world derivatives markets have grown exponentially in size and importance. As stated by Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve System, "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives."²

The derivatives markets consist of futures and option trading on exchanges located in the United States and a number of other countries. They also include the enormous global OTC market in swaps, forwards, swaptions and other derivatives. The Bank for International Settlements has reported that outstanding OTC derivatives contracts, as of June 30, 2000, had an estimated notional amount of more than \$94 trillion, while outstanding exchange-traded derivatives had an estimated notional amount of \$13.9 trillion, for a total worldwide derivatives market exceeding \$105 trillion in notional amount.³

Derivatives are financial instruments which are valued based on changes in price in an underlying commodity, rate or index. Financial derivatives – based on interest rates, currency exchange rates and securities indices – have grown to dominate the OTC market and represent a substantial portion of the exchange markets as well. Other derivatives are based on the price of energy products, metals, agricultural products, and other physical commodities.

² Alan Greenspan, Chairman, Board of Governors, Federal Reserve System, Remarks Before the Futures Industry Association (Mar. 19, 1999), at <http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm>.

³ Press Release, Bank of International Settlements, The global OTC derivatives market continues to grow, Ref. No. 36/2000E (Nov. 13, 2000), at <http://www.bis.org/press/p001113.htm>.

Commercial interests around the world use derivatives to hedge against price risks – that is, they protect themselves from the risk of adverse changes in interest rates, currency exchange rates, or prices involved in their business operations by taking an offsetting position in derivatives. Other traders speculate on price changes, thus adding liquidity to the derivatives markets. While hedging – if done properly – reduces risk in the financial markets, speculation can increase it.

In addition to providing a method of hedging price risks, derivatives exchange markets often play an important role in price discovery. Many commodity futures markets in agricultural products, metals, and energy products provide price information which forms the basis of pricing in commercial transactions for those products in the U.S. or worldwide. For this reason, it is particularly important to insure that pricing on these markets is not distorted or manipulated.

Derivatives trading has traditionally been regulated on a national level. However, the markets have now transcended national borders. Exchange markets in different countries have become linked through formal arrangements, similar products, and common market members and users. Moreover, the OTC market knows no borders and is truly global. It is dominated by a number of large U.S. and European banks and investment banks which are the world's major OTC derivatives dealers. They deal with commercial counterparties throughout the world who seek to hedge their price risk through OTC derivatives.

In such a global marketplace, no one national regulator has the information and regulatory powers needed to insure the integrity of its domestic markets. Indeed, as described below, three recent crises in the derivatives markets have posed significant threats to financial stability around the world. In response to these and similar international crises in the derivatives markets, the CFTC has recognized the inadequacy of domestic regulation to contain the potential worldwide effects of such a disaster. For the past decade, the CFTC has been leading an urgent effort to design and implement international regulatory mechanisms to address the systemic risks posed by the derivatives markets. The CFTC's efforts and the strong international support they have received are described below.

II. THE CFTC'S INTERNATIONAL ROLE

In the newly enacted Commodity Futures Modernization Act of 2000, Congress acknowledges and encourages the significant contributions of the CFTC to international regulatory cooperation relating to derivatives trading. Recognizing that “derivatives markets serving United States industry are increasingly global in scope” and that “events that disrupt financial markets and economies are often global in scope, require rapid regulatory response, and coordinated regulatory effort across international jurisdictions,” Congress expressed its view that the CFTC should “continue to coordinate with foreign regulatory authorities, to participate in international regulatory or-

ganizations and forums, and to provide technical assistance to foreign government authorities.”⁴

In enacting this provision, Congress paid tribute to the efforts of the CFTC to address the globalization of the derivatives markets and their attendant worldwide risks through increased international cooperation, information sharing, and regulatory harmonization. Those efforts have continued for more than a decade and have included the CFTC’s negotiation of memoranda of understanding (“MOUs”) providing for sharing of information with foreign derivatives regulators, the CFTC’s membership in organizations of international regulators and its provision of technical assistance to foreign regulatory authorities.

A. Memoranda of Understanding

The CFTC has entered into a large number of information-sharing MOUs with foreign regulators.⁵ These MOUs are designed to facilitate enforcement efforts in cases with cross-border aspects and to enhance oversight of markets, intermediaries and market participants.

Since 1988 the CFTC has taken the position that in general such MOUs are prerequisites to CFTC exemptions granted to foreign futures professionals offering to sell futures and options traded on a foreign board of trade to U.S. customers. Foreign futures brokers may sell foreign futures and commodity options to U.S. customers without registering with the CFTC and the National Futures Association (“NFA”)⁶ as futures commission merchants (“FCMs”) under U.S. law as long as they qualify for an exemption from the CFTC’s Part 30 rules.⁷ One of the criteria for such an exemption is that the regulator in the foreign future brokers’ home country and/or the foreign market of which the foreign futures brokers are members

⁴ Commodity Futures Modernization Act of 2000, Section 126, Pub. L. No. 106-554, § 126, 114 Stat. 2763 (2000). This new legislation significantly revises many aspects of the federal commodities laws as well as certain federal securities, banking and bankruptcy laws. The legislation excludes or exempts from the federal commodities laws certain categories of derivatives transactions, including many OTC derivatives, modernizes the regulatory regime for futures exchanges, authorizes for the first time trading in single-stock futures, and establishes a regulatory regime for derivatives clearing operations, among other things.

⁵ See generally, Commodity Futures Trading Commission, *The CFTC: An Active Partner in Global Cooperation Through Information Sharing With Other Financial Regulators*, CFTC Backgrounder, No. 4-92 (Apr. 28, 1999), at <http://www.cftc.gov/opa/backgrounder/opamou.htm>, for a description of many of the CFTC’s MOUs.

⁶ The NFA is a registered futures association under Commodity Exchange Act Section 17, 7 U.S.C. § 21. The CFTC has delegated to the NFA the responsibility to register commodity professionals, to determine their fitness and to set rules regulating sales practices and protection of customers. See 46 Fed. Reg. 53445 n.3 (Oct. 29, 1981).

⁷ See 17 C.F.R. § 30.10 (2000).

have entered into a satisfactory MOU with the CFTC.⁸ These information-sharing arrangements provide the CFTC with access to information necessary “to monitor domestic markets and to protect U.S. customers trading on foreign markets.”⁹ Information relating to foreign futures professionals, including their fitness, qualification to do business, capital, and disciplinary history may be sought, as may information concerning transactions they execute on behalf of U.S. customers.¹⁰

CFTC MOUs are also used to obtain information needed for purposes other than implementing exemptions to the Part 30 rules. For example, cooperative enforcement MOUs are designed to allow the exchange of information relevant to enforcement of futures and derivatives laws. Financial information sharing MOUs (“FISMOUs”) were initially designed to provide sufficient information to allow the host country of a foreign company to apply the capital requirements of its home country. More recently, they have facilitated regulatory risk assessment of related firms conducting business in different countries.¹¹ Of course, the CFTC and foreign derivatives regulators frequently share information on an informal basis even when no MOU is in place.

Most CFTC MOUs have been entered into between the CFTC and a derivatives regulator and/or a self-regulatory authority in a second country. However, the CFTC along with the U.S. Securities and Exchange Commission (“SEC”) has also entered into MOUs with United Kingdom authorities that relate to securities and banking issues as well as derivatives.¹² As the evolution of financial markets blurs the separation of derivatives, securities and currency markets and their participants, it is likely that more emphasis will be placed on such cross-sectoral arrangements and that the CFTC will negotiate additional cross-sectoral arrangements.

Furthermore, as described in more detail below, the CFTC has been instrumental in the creation, adoption and implementation of a significant

⁸ 17 C.F.R. Part 30, Appendix A, Interpretive Statement With Respect to the Commission’s Exemptive Authority Under § 30.10 of Its Rules (2000).

⁹ *Id.*

¹⁰ *Id.* Exemption from the Part 30 rules under 17 C.F.R. § 30.10 had been granted to futures professionals in eight countries as of May 31, 2000, pursuant to such MOUs with regulatory and self-regulatory authorities: Australia, Canada, France, Japan, New Zealand, Singapore, Spain and the United Kingdom. See Commodity Futures Trading Commission, *Regulatory and Self-Regulatory Authorities That Have Received Exemptions Under CFTC Rule 30.10*, CFTC Backgrounder, No. 12-99 (May 31, 2000), at <http://www.cftc.gov/opa/backgrounder/P30BK01A.htm>.

¹¹ As of April 28, 1999, the CFTC had entered into cooperative enforcement MOUs with authorities in seventeen countries and FISMOUs with authorities in Canada and the United Kingdom. In addition, an arrangement with authorities in Hong Kong facilitates cooperation in supervising cross-border managed futures activity. See Commodity Futures Trading Commission, *supra* note 5.

¹² See *id.*

multilateral information sharing arrangement, the Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations entered into in March 1996 in Boca Raton, Florida ("Boca Declaration") – the first such multilateral arrangement regarding derivatives markets.¹³ The Boca Declaration is designed to facilitate international regulatory information sharing concerning events that may have broad-based international financial repercussions, including significant financial problems of exchange or clearinghouse members or their customers – such as occurred to Barings Plc. – or potential market manipulation – such as that by Sumitomo Corporation.

The CFTC's bilateral and multilateral MOUs are the vehicle for numerous exchanges of information. For example, during fiscal year 1996, the CFTC requested information from foreign regulators on 190 occasions and received requests from foreign regulators on 65 occasions.¹⁴ The MOUs are invaluable in assisting derivatives regulators to obtain the information and cooperation needed to oversee a global marketplace and to detect events that may pose significant economic dangers.

B. International Organizations

In recent years international organizations have played an increasingly important role in promoting international cooperation through information sharing and regulatory harmonization. For derivatives and securities regulators, the International Organization of Securities Commissions ("IOSCO") has emerged as the leading worldwide international organization. Currently headquartered in Madrid, Spain, IOSCO, consists of securities and derivatives commissions and exchanges from around the world. As of May 2000, it had a membership of 165 entities.¹⁵ The SEC is an ordinary member of IOSCO and the CFTC is an associate member.¹⁶

The CFTC has used its role as a member of IOSCO's Technical Committee to foster improved regulatory oversight over derivatives markets and harmonization of standards for derivatives regulation worldwide. For example, the CFTC staff has worked within IOSCO to develop and update a

¹³ Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations, executed on March 15, 1996, in Boca Raton, Florida, <http://www.cftc.gov/oia/bocadec0398.htm>; Press Release, Commodity Futures Trading Commission, Press Release 3995-96 (Mar. 15, 1996), at <http://www.cftc.gov/opa/press96/declare.htm>.

¹⁴ See Brooksley Born, Chairperson, CFTC, Address before the Section of Business Law Committee on Regulation of Futures and Derivative Investments and the Derivative Instruments Subcommittee of the Federal Regulation of Securities Committee of the American Bar Association (Aug. 4, 1997), at <http://www.cftc.gov/opa/speeches/opaborn-19.htm>.

¹⁵ See International Organization of Securities Commissions, Final Communiqué of the 25th Annual Conference of the International Organization of Securities Commissions (May 2000), at <http://www.cftc.gov/opa/speeches/opaborn-19.htm>.

¹⁶ See IOSCO Membership Lists, available at <http://www.iosco.org/iosco.html>.

publication entitled *International Regulation of Derivative Markets, Products and Financial Intermediaries* (December 1996), which describes various approaches to derivatives market regulation.¹⁷

Perhaps the most significant accomplishment of IOSCO has been its adoption of the report on *Objectives and Principles of Securities Regulation* (September 1998).¹⁸ With the CFTC's assistance, this report incorporates objectives and principles of derivatives regulation as well as securities regulation. It constitutes a significant international consensus on the principles necessary to protect market participants, to ensure that markets are fair, efficient and transparent, and to reduce systemic risk. IOSCO is actively working on implementation of these principles.

The CFTC has also served on IOSCO's Internet Task Force and contributed significantly to its Technical Committee's 1998 report on *Securities Activity on the Internet* (September 1998), which includes principles to be considered when adopting regulatory policies involving Internet activities.¹⁹ The CFTC also participated in an IOSCO-sponsored Internet Surf Day on March 28, 2000, aimed at detecting securities and futures fraud on the Internet.²⁰

In addition to IOSCO, there are regional organizations of securities and derivatives regulators such as the Forum of European Securities Commissions ("FESCO")²¹ and the Council of Securities Regulators of the Americas ("COSRA").²² The CFTC is an active member of COSRA. It also participates in the activities of the Quadrilateral Group, a cross-sectoral effort that consists of U.S. and U.K. banking supervisors and securities and

¹⁷ See IOSCO, *Report on the International Regulation of Derivative Markets, Products and Financial Intermediaries (1997)*, available at http://www.iosco.org/docs-public/download_1996_regulation_of_derivative_markets.html; Commodity Futures Trading Commission, Annual Report 64, <http://www.cftc.gov/annualreport97/chair97.htm>; Press Release, Commodity Futures Trading Commission, *CFTC Announces Availability of the International Regulation of Derivative Markets, Products and Financial Intermediaries and 1997 Status Report on Exchange-Traded Derivatives Markets in Emerging and Developing Countries*, Press Release 4054-97 (Sept. 19, 1997), available at <http://www.cftc.gov/opa/press97/4054-97.htm>.

¹⁸ See IOSCO, *Objectives and Principles of Securities Regulation* (Sept. 1998), at <http://www.iosco.org/docs-public/1998-objectives.html>; Commodity Futures Trading Commission, Annual Report 97 (1998), available at <http://www.cftc.gov/annualreport98/chair98.htm>.

¹⁹ See IOSCO, *Securities Activity on the Internet* (Sept. 1998), available at http://www.iosco.org/docs-public/1998-internet_security.html.

²⁰ See Press Release, Commodity Futures Trading Commission, *CFTC Participates in International "Internet Surf" Day to Uncover Fraudulent Promotion of Commodity Schemes*, Press Release 4399-00 (May 15, 2000), at <http://www.cftc.gov/opa/enf00/4399-00.htm>.

²¹ See, e.g., <http://www.eurofesco.org/v1/default.asp> (website of FESCO).

²² COSRA, founded in 1992, is an organization of market regulators from 26 nations in the Western Hemisphere and is dedicated to the promotion of market integrity. See <http://www.cvm.gov.br/ingl/inter/Cosra/inter.asp> (website of COSRA).

derivatives regulators.²³ Furthermore, the CFTC hosts a day-long meeting of international derivatives regulators once a year in March in Boca Raton, Florida at the Annual Meeting of the Futures Industry Association ("FIA"), a trade association of futures professionals.²⁴

These international organizations provide forums in which international regulators may form a consensus about appropriate regulatory goals and standards and about international cooperation for regulating global markets. They have played a significant role in enhancing the level and quality of international regulation in derivatives markets. They also bring regulators from all over the world together and foster personal relationships which facilitate cooperation and communication during emergencies.

C. Technical Assistance

In addition to its efforts to negotiate MOUs and its activities through international organizations such as IOSCO and COSRA, the CFTC has provided extensive technical assistance to derivatives regulators in other countries. Since 1990 the CFTC has annually sponsored a training seminar for international market authorities.²⁵ In recent years, the seminar has been a week-long program held in Chicago, Illinois, for staff members of foreign regulators and markets. It focuses on standards and techniques of effective oversight of derivatives markets to preserve market integrity and to promote customer protection. CFTC senior staff, Chicago exchange authorities, representatives of the NFA and the FIA, and other recognized experts in the derivatives field participate as teachers in the training effort. During the past decade, hundreds of staff members of foreign regulators and foreign markets have received this intensive tutoring in how to regulate their derivatives markets effectively and at the same time have had the opportunity to meet and get to know their counterparts from around the world. The CFTC training seminars have made a significant contribution in fostering international regulatory cooperation relating to derivatives and raising the level of derivatives regulation worldwide.

These training seminars have been supplemented by CFTC technical assistance to individual foreign regulatory authorities, ranging from training sessions designed for the staff of a foreign regulator to extended visits by a member of the staff of a foreign regulator with the CFTC to observe its op-

²³ See Commodity Futures Trading Commission, Annual Report 63 (1997), available at <http://www.cftc.gov/annualreport97/chair97.htm>.

²⁴ See, e.g., Press Release, Commodity Futures Trading Commission, *International Futures Regulators Meeting*, Press Release 4381-00 (Mar. 16, 2000), at <http://www.cftc.gov/opa/press00/opa4381-00.htm>.

²⁵ See <http://www.cftc.gov/cftc/cftcinternational.htm#TrainingSeminarforForeignMarketAuthorities>.

erations. Informational materials and consultation are regularly provided by the CFTC staff to foreign regulatory authorities.

In addition, the CFTC staff undertakes to study and report on many issues relevant to international derivatives regulation. For example, in 1999 alone the CFTC published a study on *Regulation of OTC Derivatives Transactions*²⁶ based on the regulatory regimes of sixteen countries, a report entitled *Exchange-Traded Derivatives in Developing Capital Markets Report*²⁷ based on a survey of jurisdictions with developing capital markets, and a survey on *Futures Exchange and Contract Authorization Standards and Procedures in Selected Countries* (August 1999).²⁸ These surveys and reports have contributed greatly to international understanding of the existing variations in derivatives regulation, international consensus on best practices for derivatives regulation, and international enhancement of the quality of derivatives regulation.

D. Office of International Affairs and Global Markets Advisory Committee

In recognition of the growing importance of its international activities, the CFTC created an Office of International Affairs in July 1997 to centralize and facilitate such activities.²⁹ As stated in the CFTC's 1997 Annual Report, "The Office of International Affairs will enhance the Commission's ability to meet the challenges posed by globalization of financial markets in three important ways: (1) to respond quickly to market crises that have global systemic implications; (2) to remain an effective supervisor in a global marketplace where no one regulator has all the information or resources to regulate its markets or its firms; and (3) to eliminate unnecessary impediments to global business while preserving core protections for markets and customers."³⁰

²⁶ See Commodity Futures Trading Commission, *Regulation of Over-The-Counter Derivatives* (March 1999), available at <http://www.cftc.gov/files/oia/oiaotcs99a.pdf> and <http://www.cftc.gov/files/oia/oiaotcs99b.pdf>.

²⁷ See Commodity Futures Trading Commission, *Exchange-Traded Derivatives in Developing Capital Markets Report* (1999), available at <http://www.cftc.gov/files/oia/oiadcmrpt1.pdf>.

²⁸ See Commodity Futures Trading Commission, *Futures Exchange and Contract Authorization Standards and Procedures in Selected Countries* (1999), available at <http://www.cftc.gov/files/oia/oiamarketcontracts.pdf>.

²⁹ See Press Release, Commodity Futures Trading Commission, *CFTC Establishes Office of International Affairs*, Press Release 4034-47 (July 8, 1997), available at <http://www.cftc.gov/opa/press97/4034-97.htm>. The Director of the Office of International Affairs, Andrea Corcoran, had been for many years Director of the CFTC's Division of Trading and Markets. In both roles she has been a leader in the CFTC's international activities and largely responsible for their success.

³⁰ Commodity Futures Trading Commission, Annual Report 9 (1997), available at <http://cftc.gov/anr/anrcontents97.htm>.

The CFTC also believes that it is appropriate to reach out to derivatives industry participants for views and guidance on the CFTC's international activities. For this reason, the CFTC created a Global Markets Advisory Committee in February 1998, consisting of representatives of U.S. derivatives markets, intermediaries and market participants.³¹ As I stated in welcoming the members of the Advisory Committee to its first meeting on May 14, 1998:

Our exchanges deserve a level playing field in which foreign markets are subject to effective regulation. Market participants should also be free to use markets around the world with the assurance that these markets are safe and sound and without the burdens of unnecessary regulatory complexity and diversity. Differences in regulatory approaches will undoubtedly continue, reflecting different cultures and legal systems. However, it is incumbent on regulators to work toward harmonization so that regulation does not unnecessarily impede investment decisions and economic innovation. The information and suggestions provided by this Committee will assist the Commission in evaluating our activities to achieve those goals.

The Advisory Committee has provided a forum for interested members of the industry to alert the CFTC to areas in which international divergence in regulatory standards creates barriers to participation in the global markets and to areas in which a lack of international regulatory cooperation poses unnecessary dangers to financial stability.

It is within this context of a network of MOUs, membership in international organizations, and active provision of technical assistance to foreign regulators that the CFTC responded to three international derivatives crises in the mid-to-late 1990s. The resulting framework of interrelationships with foreign regulators that had been established by the CFTC assisted greatly in its international activities in response to these crises, as is described below.

III. THE BARINGS BANK FAILURE

The failure of Barings Plc. ("Barings") is a prime example of the broad scope of international activities of many derivatives market participants and the potential international repercussions from their missteps. Barings, a large, old, and established British merchant bank, had worldwide affiliates and operations and traded on numerous world futures markets, including those in Singapore, Japan, Hong Kong and the United Kingdom. Barings suffered financial collapse in February and March 1995 because of the al-

³¹ See 63 Fed. Reg. 10595 (Mar. 4, 1998); Commodity Futures Trading Commission Annual Report 13 (1998), available at <http://www.cftc.gov/annualreport98/YIR98.htm>.

legedly unauthorized derivatives trading activities of a young employee of a Barings affiliate in Singapore on Singapore and Japanese futures markets that resulted in losses exceeding a billion dollars. Significant international economic repercussions from the incident were averted only because ING, a Dutch bank, stepped in to take over Barings.³²

A. Efforts to Contain the U.S. Impact

In response to the failure of Barings,³³ the CFTC immediately evaluated the potential impact of the failure for U.S. markets and U.S. firms. Thus, the CFTC promptly investigated the extent of any direct participation or trading, activity by Barings or its affiliates in the U.S. futures markets. It also investigated whether U.S. FCMs had business relationships with Barings – for example, whether they were clearing or executing trades through Barings or its affiliates on foreign markets. These investigations did not reveal any significant concerns.

Nonetheless, a number of U.S. FCMs had subsidiaries that cleared through the Singapore and Japanese derivatives exchanges involved in the Barings trading and there was a need to protect the U.S. firms and their affiliates from significant losses on those foreign exchanges. The CFTC staff spent a great deal of time and effort in negotiating with the foreign exchanges and their regulators to protect margin funds deposited by U.S. firms with those foreign exchanges and to prevent their being used to reimburse Barings' losses. The CFTC staff also worked to facilitate the transfer

³² See, e.g., Marcus W. Brauchli, *Many Who Knew Barings PLC Suggest Firm Wasn't Model Corporate Citizen*, WALL ST. J., Mar. 8, 1995, at A16; Peter Martin, *Death Came Sudden and Swift for Barings*, THE FIN. POST, Mar. 4, 1995, at 6; Marcus W. Brauchli and Jeremy Mark, *Barings, Unlikely to Tarnish Singapore Markets for Long*, WALL ST. J., Mar. 1, 1995, at C1.

³³ For detailed descriptions of the CFTC's response to the Barings crisis, see Brooksley Born, Chairperson, CFTC, Address before the Section of Business Law Committee on Regulation of Futures and Derivative Investments and the Derivative Instruments Subcommittee of the Federal Regulation of Securities Committee of the American Bar Association (Aug. 4, 1997), at <http://cftc.gov/opa/speeches/born-19.htm>; Testimony of John E. Tull, Jr., Acting Chairman, CFTC, before the House Committee on Appropriations Subcommittee on Agriculture, Rural Development, FDA, and Related Agencies, (Mar. 14, 1996), available at <http://www.cftc.gov/opa/speeches/testimon.html>; Joseph B. Dial, Commissioner, CFTC, Address before IDB/ISDA Latin America Derivatives Conference (Nov. 10, 1995), at <http://www.cftc.gov/opa/speeches/idbsingl.html>; Joseph B. Dial, Commissioner of the CFTC, Address at 18th Annual Commodities Law Institute and the 4th Annual Financial Services Law Institute Conference (Oct. 19, 1995), at <http://www.cftc.gov/opa/speeches/chic955.html>; Mary L. Schapiro, Chairman, CFTC, Address at the 18th Annual Commodities Law Institute and the 4th Annual Financial Services Law Institute Conference (Oct. 19, 1995), at <http://www.cftc.gov/opa/speeches/kent2.html>; Suzanne McGee, *CFTC's New Chairman Carves Success Story From Barings Crisis*, ASIAN WALL ST. J., May 17, 1995, at 17; John M. Berry and Clay Chandler, *Bank Failure Set Off Race To Cut Harm; U.S., Other Officials Acted in Barings Case*, WASH. POST, Mar. 1, 1995, at C1.

of derivatives positions held by U.S. customers or U.S. firms at the foreign exchanges. Finally, the CFTC was alert to the potential impact on U.S. exchanges and their member firms from heightened volatility in domestic markets relating to the Barings crisis.

B. The Windsor Declaration

The experience of the CFTC and foreign derivatives regulators during the Barings collapse highlighted the need to put in place methods of coping with the extraterritorial impact of such crises in the future. The Barings incident showed that the default of a major financial institution because of speculation in the derivatives markets clearly could pose undue risks to the world's financial fabric. The CFTC believed that improved communication among regulators and exchanges globally, international understandings to limit and contain risk relating to such defaults, and the ability to clear, transfer, and protect the positions of other market participants during such a crisis were critically important.

The first step by the CFTC to address these problems internationally was to co-sponsor a conference held in Windsor, England, in May 1995 with the United Kingdom's Securities and Investment Board ("SIB"), the agency then overseeing securities and derivatives markets in the U.K. Regulatory authorities from sixteen countries with major futures and option markets attended the meeting and addressed the international regulatory issues posed by the Barings collapse and similar large defaults.³⁴ The two-day meeting resulted in the issuance of the Windsor Declaration, which focused on "specific co-operative measures to strengthen regulatory supervision, minimize systemic risk, and enhance customer protection with a view to preventing or containing the adverse effects of financial disruptions."³⁵

The Windsor Declaration adopted recommendations relating to four major areas: cooperation between market authorities; protection of customer positions, funds and assets; default procedures; and regulatory cooperation in emergencies. It was agreed that information sharing and cooperation among markets and their regulators concerning large exposures and other regulatory concerns should be explored and promoted. In addition, the development of mechanisms to protect customer positions, funds and assets during a firm's insolvency would be pursued, as would methods of containing financial disruption related to a firm's default or collapse. Finally, it

³⁴ See *Commodity Markets: Regulators Meet on Futures Trade*, WALL ST. J. EUR., May 18, 1995, at 17.

³⁵ Windsor Declaration, issued at Windsor, England on May 17, 1995, available at <http://www.cftc.gov/oia/windsordeclaration.htm>. The signatories to the Windsor Declaration are regulators from Australia, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, South Africa, Spain, Sweden, Switzerland, the United Kingdom and the United States. See *id.*

was agreed to develop mechanisms to enhance cooperation and communication among regulators during emergencies.

The Windsor Declaration committed each signatory to take action necessary to promote the recommendations at a domestic level. It further provided that IOSCO would undertake the implementation of the recommendations through its Technical Committee. At IOSCO's 1995 Annual Meeting that summer, IOSCO's President's Committee adopted a resolution urging IOSCO members to "take all steps that are necessary and appropriate in their home jurisdictions to endorse and promote the measures agreed upon in the Windsor Declaration to all cross-border transactions" and authorized IOSCO's Technical Committee to implement the recommendations in the Windsor Declaration.³⁶ All 72 member countries of IOSCO endorsed the Windsor Declaration at that meeting.³⁷

A number of IOSCO initiatives resulted from the Windsor Declaration. Through its Technical Committee, the CFTC spearheaded efforts that produced international consensus documents on cooperation between market authorities, default procedures at exchanges and client asset protection.³⁸ Each of these reports contributed significantly to the ability of the international regulatory community to deal with a default like that of Barings.

C. The Boca Declaration

Perhaps the most notable international regulatory accomplishment in the aftermath of the Barings collapse was the March 15, 1996 Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organisations signed in Boca Raton, Florida ("Boca Declaration") and its companion document, a Memorandum of Understanding executed by derivatives exchanges and clearinghouses.³⁹ The Boca Declaration was initially signed by derivatives regulators from fourteen jurisdictions, while the Memorandum of Understanding among exchanges and clearing organizations involved 49 organizations from 18

³⁶ IOSCO President's Committee, *A Resolution Concerning Cross-Boarder Transactions* (July 1995), at <http://www.iosco.org/resolutions/resolutions-document15.html>.

³⁷ See Mary L. Schapiro, Chairman, CFTC, Address at the 18th Annual Commodities Law Institute and the 4th Annual Financial Services Law Institute Conference (Oct. 19, 1995), at <http://www.cftc.gov/opa/speeches/kent2.html>.

³⁸ IOSCO Technical Committee, *Client Asset Protection* (Aug. 1996), http://www.iosco.org/docs-public/1996-client_asset_protection.html; IOSCO Technical Committee, *Report on Cooperation Between Market Authorities and Default Procedures* (Mar. 1996), at http://www.iosco.org/docs-public/1996-report_on_cooperation.html; IOSCO Technical Committee, *Report on Margin* (Mar. 1996), at <http://www.iosco.org/iosco.html>; see Commodity Futures Trading Commission, Annual Report 62 (1996), at <http://www.cftc.gov/annualreport96/tmrev96.html>.

³⁹ Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organisations, executed on March 15, 1996, in Boca Raton, Florida, available at <http://www.cftc.gov/oia/bocadec0398.htm>.

countries.⁴⁰ The CFTC, along with the SIB, played an instrumental role in developing the Boca Declaration and hosted the meeting of international regulators at which it was signed.⁴¹

Both the Boca Declaration and the Memorandum of Understanding provide for bilateral information sharing between signatories. Under these arrangements, information sharing is triggered by events relating to significant financial reverses of a member of an exchange or clearing organization. The Boca Declaration provides that a regulatory authority may request information relevant to the triggering event and that information will be provided to the extent that the authority receiving such request has access to the requested information. The Memorandum of Understanding provides that exchanges and clearinghouses are to share information bilaterally with other exchanges and clearinghouses to the extent permitted by law and are to allow their regulatory authorities to act as intermediaries or gateways to pass information where the exchanges or clearinghouses themselves may not do so. The information received pursuant to a request is to be used solely for carrying out the supervisory responsibilities of the regulator, exchange or clearinghouse requesting the information, and its use is subject to such conditions as the provider of the information may request in light of its laws. The Boca Declaration also contains provisions relating to the confidentiality of the information shared.

These arrangements were the first multilateral information-sharing agreements relating to derivatives trading and were the first complementary agreements among regulators on the one hand and derivatives exchanges and clearing organizations on the other. The arrangements facilitate one another, with regulators supporting the efforts of exchanges and clearinghouses to share information with one another as needed to protect their markets from disruption and stepping in where needed to implement such information sharing. Furthermore, the Boca Declaration recognizes that regulatory authorities themselves may need to seek information to perform their regulatory functions and details the circumstances in which such a request may be made and the mechanism for making the request.

With the adoption of these arrangements, the need for swift warning and information exchange concerning potential defaults was recognized, and a mechanism for accomplishing these goals was put in place. Derivatives regulators and markets were thus in an improved position to react ef-

⁴⁰ The original signatories of the Boca Declaration, in addition to the CFTC and the SIB, included regulatory authorities from Australia, Austria, Canada, France, Germany, Hong Kong, Ireland, Italy, the Netherlands, Singapore, South Africa and Spain. *See id.* *See also* Press Release, Commodity Futures Trading Commission, *International Futures Regulators From 14 Jurisdictions Sign Declaration on Cooperation and Supervision Covering International Futures Markets*, Press Release 3995-96 (Mar. 5, 1996), available at <http://www.cftc.gov/opa/press96/declare.htm>.

⁴¹ *See id.*

fectively to crises in the international markets. Unfortunately, they did not have long to wait.

IV. SUMITOMO CORPORATION'S MANIPULATION OF THE COPPER MARKET

Within three months of the adoption of the Boca Declaration, Sumitomo Corporation of Japan ("Sumitomo") announced on June 13, 1996, that it had lost an estimated \$1.8 billion—later raised to \$2.6 billion—through trading in copper futures and options on the London Metal Exchange ("LME").⁴² Sumitomo is a Japanese corporation that sells copper throughout the world and in that connection engages in copper futures and option transactions on the New York Mercantile Exchange ("Nymex") and LME to hedge its price risks. Sumitomo maintained that its losses were caused by unauthorized speculative trading in copper derivatives by the employee in charge of its copper trading, Yasuo Hamanaka. Because of its vast resources, Sumitomo was able to absorb its losses without default.

However, the Sumitomo incident went beyond large losses and the potential of default in the derivatives markets and thus was not a mere repeat of the Barings affair. As was demonstrated later through investigation by the CFTC, Sumitomo had used the LME and OTC derivatives markets to manipulate the price of copper in the U.S., thus costing consumers and commercial interests billions of dollars.

A. Efforts to Contain the U.S. Impact

The CFTC staff had been concerned about prices in the global copper market and particularly on Nymex and LME since early 1995.⁴³ Their surveillance information demonstrated that pricing in the market was abnormal, and they suspected that the market was being manipulated. The price of futures on both LME and Nymex became increasingly volatile during 1995, and significant backwardation in the pricing occurred, indicating a price distortion.⁴⁴ LME had opened copper warehouses in the United States and established U.S. delivery points for its copper futures contracts during

⁴² See, e.g., Reed Abelson, *Sumitomo Says It Found Loss Of \$1.8 Billion*, N.Y. TIMES, Jun. 14, 1996, at D1; Sandra Sugawara, *Japanese Copper Trader Arrested, Accused of Fraud*, N.Y. TIMES, Oct. 23, 1996, at A24.

⁴³ See generally, Testimony of Brooksley Born, Chairperson, CFTC, Before the House of Representatives Committee on Banking and Financial Services, September 18, 1996, for a description of the Sumitomo losses and the CFTC's responses to disruption in the copper markets in 1995 and 1996, at <http://www.cftc.gov/opa/speeches/born-1.html>.

⁴⁴ The sustained backwardization of pricing on the LME and Nymex copper markets was an indication of an artificial impact on price. Backwardization is a market condition in which the price of the commodity for near-term delivery is at a premium to the price of the commodity for deferred delivery. Sustained backwardization may indicate that a squeeze is being placed on current stocks.

1995, which increased the effect that activity on LME had on prices on Nymex and in the U.S. cash market for physical copper. The CFTC staff also detected unusual activity in warehouse stocks. The CFTC's enforcement investigation later revealed that, by the Fall of 1995, Sumitomo owned almost all of the LME warehouse stocks in copper and held a massive position on LME, causing a sharp increase in cash copper prices and a significant backwardation in futures prices in the U.S.⁴⁵

The CFTC's investigation of positions on the Nymex copper market did not reveal any cause of the abnormal activity and prices, and the CFTC requested information from the U.K. SIB concerning transactions on LME. The CFTC had available to it very effective market surveillance methods, including large trader reports of positions in copper futures and options on Nymex.⁴⁶ However, the SIB did not have the regulatory tools necessary to investigate market positions of Sumitomo or other customers on LME. Moreover, competitive rivalry between LME and Nymex frustrated information sharing between the two exchanges and initially may have influenced the willingness of the SIB to share information with the CFTC. Therefore, the CFTC was frustrated in its ability to investigate the causes of the price abnormalities during 1995 because it was limited to information about the U.S. markets. At a time when Sumitomo's manipulative scheme might have been stopped before great harm was caused to copper market participants, the CFTC's hands were tied by lack of information.

When Sumitomo informed the CFTC of its enormous losses and its plan to announce them publicly in June 1996, the CFTC took immediate steps to contain the financial impact of that announcement in the United States. The CFTC asked that Sumitomo also announce that it would stand behind its copper obligations, act responsibly in the marketplace and cooperate in the CFTC's investigation of its activities. Sumitomo's announcement to that effect acted as a damper on price volatility in the market and prevented the panic that might have occurred if market participants had believed that Sumitomo would default on its obligations.

The CFTC promptly notified the other members of the President's Working Group on Financial Markets – the Board of Governors of the Federal Reserve System, the Department of the Treasury and the SEC – about Sumitomo's pending announcement and details of the situation. The members of the President's Working Group were thereafter kept informed of the CFTC's surveillance of the copper markets and its investigation of possible manipulation.

The CFTC also made an immediate assessment of the likely impact of Sumitomo's announcement in the U.S. The CFTC established promptly

⁴⁵ See *In the Matter of Sumitomo Corp.*, COMM. FUT. L. REP. (CCH) ¶ 27,327 (1998), available at <http://www.cftc.gov/ogc/oporders98/fsumitomo.html>.

⁴⁶ See 17 C.F.R. §§ 15.00, 15.01, 15.03, 17.00, 18.00 (2000).

through the large trader reporting system that neither Sumitomo nor any related firm had large positions on any U.S. markets and that Sumitomo was not acting as a broker for any U.S. customers. The CFTC also identified U.S. entities with large positions in copper futures or options on Nymex and was able to assess the impact of likely price volatility in the copper market on U.S. clearing firms.

At this point, the CFTC for the first time invoked the Boca Declaration, which it was authorized to do because of the triggering event of the large Sumitomo losses. The CFTC requested information from the SIB about the positions of Sumitomo and the affiliates of U.S. firms on the LME copper market. The SIB now recognized the seriousness of the situation and became more responsive to the CFTC's information requests. Nonetheless, there still remained some confusion and disagreement about what information was relevant for regulatory purposes and what information might be competitively sensitive.

Based on information gathered in the U.S. by the CFTC and information provided to it by the SIB, the CFTC examined the potential exposure of U.S. firms that were carrying positions on LME for Sumitomo through their U.K. affiliates in order to assess the potential for financial impact on the U.S. firms. In consultation with the SIB, the CFTC confirmed that it was unlikely that Sumitomo would default or become insolvent and that therefore, the primary financial risk was from potentially severe fluctuations in the price of copper. Information was shared about the identity and positions of U.S. based firms with the largest positions on LME and the exposure of U.S. firms to fluctuations in copper prices. Information concerning the excess capital at U.K. affiliates of U.S. firms indicated that such firms would likely be able to weather a period of severe price fluctuation. The CFTC's ability to obtain this information from the SIB demonstrated the usefulness of the Boca Declaration, although the CFTC and the SIB also became aware of some weaknesses in implementing the Boca Declaration which needed to be addressed.

Because Sumitomo had a very deep pocket, its loss of \$2.6 billion did not have severe and wide-spread financial repercussions. Unlike Barings, Sumitomo was not rendered insolvent and did not need to be rescued by a take-over. Moreover, price volatility on the copper markets did not cause other major firms to default. Nonetheless, the impact of Sumitomo's activities on world copper prices did have a profound economic impact both within the U.S. and abroad. As the CFTC investigation revealed, Sumitomo manipulated the price of copper in what may well have been the most significant commodity price manipulation since the Hunt brothers' manipulation of the world market in silver in 1979 and 1980.

B. Enforcement Actions

In December 1995 the CFTC instituted an enforcement investigation into whether the copper markets were being manipulated. The CFTC en-

forcement staff conducted a broad-based investigation of Sumitomo's activities in close cooperation with U.K. and Japanese authorities. As a result of that investigation, on May 11, 1998, the CFTC issued an order finding that Sumitomo had manipulated the copper market in 1995 and 1996 through its actions on LME, which caused artificially high prices in U.S. cash and futures markets in copper.⁴⁷ Because of Sumitomo's actions, copper prices had risen to a high of about \$2,800 per metric ton in late 1995 and early 1996 and then fell abruptly to below \$2,000 after Sumitomo re-assigned Mr. Hamanaka in May 1996. Sumitomo had also used OTC transactions in furtherance of its manipulative scheme, both to obtain financing and to disguise the speculative nature of its transactions.⁴⁸

Sumitomo settled this matter with the CFTC by agreeing to an order in which the CFTC ordered that Sumitomo cease and desist from further violation of the manipulation provisions of the Commodity Exchange Act.⁴⁹ The CFTC also ordered Sumitomo to pay a total of \$150 million, of which \$125 million was paid to the United States Treasury as a civil monetary penalty. At that time, this was the largest civil monetary penalty that the United States government had ever imposed. The additional \$25 million was paid into escrow to provide restitution to U.S. persons injured by Sumitomo's unlawful conduct.

In addition, the CFTC found that Merrill Lynch International, Inc. and Merrill Lynch Pierce Fenner and Smith (Brokers & Dealers), Ltd. had aided and abetted Sumitomo by providing more than \$500 million of credit which Sumitomo used to purchase and hold a dominant position in LME futures contracts and LME warehouse stocks of copper and through other activities. The CFTC settled with those companies in June 1999, ordering them to pay a civil monetary penalty of \$15 million and to cease and desist from violating and aiding and abetting violations of the anti-manipulation provisions of the commodities laws.⁵⁰

The level of cooperation with U.K. and Japanese authorities in conducting the enforcement investigations into this matter was unprecedented and led to successful legal and disciplinary actions in all three countries. The ease of international information sharing in the enforcement area contrasted sharply with the difficulties experienced in earlier market surveillance efforts. This difference was probably due to the extensive experience

⁴⁷ See *In the Matter of Sumitomo Corp.*, *supra* note 45.

⁴⁸ *Id.*

⁴⁹ *Id.* Sumitomo was ordered to cease and desist from violating Commodity Exchange Act §§ 6(c), 6(d) and 9(a)(2), 7 U.S.C. §§ 9(c), 13b(d), 13(a)(2).

⁵⁰ See *Order Making Findings and Imposing Remedial Sanctions As to Respondents Merrill Lynch, Pierce, Fenner & Smith (Brokers & Dealers), Ltd. and Merrill Lynch International, Inc. and Dismissing the Proceeding as to Respondent Merrill Lynch & Co.*, COMM. FUT. L. REP. (CCH) ¶ 27,686 (1999).

of the CFTC and the SIB in enforcement cooperation and the novelty of sharing pre-enforcement market surveillance data.

C. International Initiatives

In the aftermath of the Sumitomo problem, the SIB announced a public review of LME and the adequacy of its regulatory powers and market oversight. The CFTC commented during the review, urging that the U.K. adopt large trader reporting so that its markets and regulatory authorities could detect efforts at manipulation. If the U.K. had had large trader reporting similar to that available to the CFTC, the SIB and CFTC would have been able to detect Sumitomo's manipulative scheme by sharing information at a much earlier stage. The CFTC also pointed out that Sumitomo's large losses were hidden for a long period because of extensions of credit allowed by U.K. futures markets. The CFTC suggested that the SIB consider requiring the collection of variation margin and daily mark to market and settlement of trades, thus precluding large long-term unsecured credit risks in the derivatives markets.

As noted above, the Sumitomo matter was the first occasion on which the CFTC attempted to exercise its rights to request information pursuant to the Boca Declaration. The experience of the CFTC and the SIB indicated that undue delay in sharing market information could occur even between well-intentioned regulators because of issues concerning the scope and relevancy of information requested. The Sumitomo incident had confirmed that information sharing may be important to market oversight and regulation even before any enforcement actions are envisioned and that the information needed may involve the state of the market as a whole as well as the situation of particular market participants. The Boca Declaration did not adequately address issues relating to the types of information which should be shared in a market crisis. Furthermore, it focused on default of a firm and did not address market manipulation and price distortion. The competition between LME and Nymex had prevented information-sharing between them, confirming the need for information sharing between regulators as authorized in the Boca Declaration.

In light of this experience, the CFTC and the SIB proposed to the IOSCO Technical Committee in September 1996 that it develop a framework describing the types of information needed by international regulators during particular types of market events, thus allowing regulators to have an advance understanding of what information would likely be requested and should be provided. The Technical Committee agreed to do so and, with the assistance of the CFTC and the SIB, subsequently issued its report entitled *Guidance on Information Sharing* (November 1997), which focused on the information to be shared in three circumstances: a financial crisis at a firm, a major market-wide price move, and unusual price movements or

market volatility in a particular contract.⁵¹ This report should facilitate prompt sharing of relevant information during a market crisis.

D. The Tripartite Conferences

The CFTC, the SIB and derivatives regulators from Japan agreed to convene a meeting of international regulators of commodity futures markets to discuss the implications of the Sumitomo affair for derivatives market regulation and international cooperation.⁵² The Japanese authorities participating in this tripartite effort were the Ministry of International Trade and Industry ("MITI"), which regulates Japanese futures markets in metals and energy, and the Ministry of Agriculture, Forestry and Fisheries ("MAFF"), which regulates futures markets in agricultural products. The co-sponsors believed that Sumitomo's manipulation of the copper markets demonstrated that derivatives markets in international commodities involving physical delivery, such as copper, posed special regulatory issues and concerns, especially relating to the availability of deliverable supplies and susceptibility to market manipulation. The co-sponsors also thought that it was appropriate for the three countries most involved in the Sumitomo matter to take responsibility for bringing together other regulators of physical commodity markets.

At the invitation of the co-sponsors, regulatory authorities responsible for supervising commodity futures markets from 16 countries met on November 25 and 26, 1996, in London to discuss these issues.⁵³ At the end of the meeting they issued the London Communiqué on Supervision of Commodity Futures Markets.⁵⁴ In the Communiqué, the regulators recognized that futures contracts based on an underlying physical commodity – and particularly those requiring physical delivery – pose particular concerns for market integrity and the supervision of such markets. The Communiqué notes that "no forum to date has addressed the particular concerns raised by markets whose underlying product is a physical commodity."⁵⁵

The regulators decided to focus on contract specifications, market surveillance and information sharing and cooperation relating to such markets. Consensus was reached on a number of points, including the following:

⁵¹ IOSCO Technical Committee, *Guidance on Information Sharing* (Nov. 1997), at http://www.iosco.org/docs-public/1998-guidance_information_sharing_document02.html.

⁵² See generally, Tokyo Commodity Futures Markets Regulators' Conference (Oct. 1997), available at <http://www.cftc.gov/oia/Tokyorpt.pdf>.

⁵³ See *id.* The participants in the meeting included regulatory authorities from Australia, Brazil, Canada, France, Germany, Hong Kong, Hungary, Italy, Japan, Korea, Malaysia, the Netherlands, Singapore, South Africa, the United Kingdom and the United States.

⁵⁴ See *id.* at 31 (reproducing text of London Communiqué on Supervision of Commodity Futures Markets).

⁵⁵ *Id.* at 32.

- proper contract design is critical to reducing the susceptibility of such contracts to market abuses, including manipulation, and is an important complement to an appropriate market surveillance program;
- an effective market surveillance program of such markets should be designed to detect and prevent abusive conduct and requires that market authorities have access to necessary information;
- market authorities of related markets should share surveillance information in order to manage market disruption; and
- regulatory measures that facilitate the identification of large exposures should be developed and may involve access to information relating to the persons controlling large exposures and their related exchange, OTC and cash market positions as well as access to information on deliveries.

The regulators decided to undertake further work on these issues. The participants would survey current practices concerning the review of contract terms, practices and procedures with respect to market surveillance and the type of surveillance information that may be obtained, and existing regulatory powers to adopt measures designed to prevent or inhibit abusive conduct. It was also decided to develop standards of best practices for the design and review of commodity contracts and for market surveillance to detect and prevent abusive conduct, including procedures to identify large exposures. Further, it was decided to examine existing information sharing arrangements including the Boca Declaration to assess their adequacy. Support for IOSCO's ongoing effort to categorize and prioritize the information to be shared during particular market events was also agreed upon. Working parties were established to conduct these efforts, and it was agreed to complete the work within twelve months and to meet again in Japan at that time.

The working parties conducted surveys of the conference participants on contract design standards, market surveillance practices and information sharing arrangements in early 1997, and the results of the surveys were published in June 1997 at the London International Derivatives Week Conference.⁵⁶ At the same time, a subcommittee of IOSCO's Consultative Committee, consisting of representatives of futures exchanges and other derivatives self-regulatory organizations, published a report with its views on these subjects.⁵⁷ The Consultative Committee had been asked to assist the

⁵⁶ COLLATION OF RESPONSES RECEIVED FROM REGULATORY AUTHORITIES TO THE SURVEYS ON CONTRACT DESIGN, MARKET SURVEILLANCE AND INFORMATION SHARING (June 1997).

⁵⁷ RESPONSE TO THE SURVEY OF OPINION REGARDING "BEST PRACTICES" FOR TERMS AND CONDITIONS OF COMMODITY CONTRACTS AND SURVEILLANCE OF COMMODITY MARKETS AND OVER-THE-COUNTER (OTC) COMMODITY FUTURES ACTIVITIES ("MARKET SURVEILLANCE"),

working parties by gathering the views of futures exchanges and their members.

On October 30 and 31, 1997, the regulators met again in Tokyo, Japan and issued the Tokyo Communiqué on Supervision of Commodity Futures Markets.⁵⁸ The participants adopted and published standards of best practice for the markets – *Guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts* (“Contract Design Guidance”) and *Guidance on Components of Market Surveillance and Information Sharing* (“Market Surveillance Guidance”).⁵⁹

The Contract Design Guidance adopts the following standards:

- a competent market authority should establish a clear framework for contract design and review criteria and procedures and should have the power to amend the provisions of existing contracts which are susceptible to manipulative or disorderly market conditions;
- contracts should meet risk management and/or price discovery needs;
- contract terms should reflect the operation of the underlying cash market and should avoid impediments to delivery;
- settlement and delivery procedures should reflect the underlying cash market and promote price convergence between the futures market and the cash market;
- the views of potential market users should be taken into account in designing contracts;
- information concerning contract terms and conditions and information concerning delivery and pricing should be readily available to market authorities and market users; and
- contract design standards should complement, but not be a substitute for, appropriate market surveillance.

The Market Surveillance Guidance includes the following standards:

- each market authority should have a clear framework for conducting market surveillance, compliance and enforcement activities, and there should be oversight of those activities;
- information should be collected on a routine and non-routine basis for on-exchange, OTC and cash markets, including information that permits market authorities to identify market

Subcommittee on the London Communiqué of the Consultative Committee of IOSCO, London Communiqué Project (May 30, 1997).

⁵⁸ Tokyo Commodity Futures Markets Regulators’ Conference, *supra* note 52.

⁵⁹ *Id.* at 13-30.

users' positions, concentrations of positions and the composition of the market;

- collection and analysis of such information should occur speedily;
- effective emergency powers should be available to intervene in the market to prevent or address abusive practices or disorderly conditions;
- effective power should be available to discipline market members;
- a relevant authority should also have power to address abusive actions of non-members of the market; and
- market authorities should cooperate to share information on large exposures.

These Guidances are the first multilateral international documents incorporating best practice standards for regulation of the derivatives markets and thus were an extremely significant step in demonstrating the existence of a consensus among the world's regulators of such markets. They also represented a significant step toward enhancing and harmonizing regulation of these markets. The Guidances establish worldwide regulatory benchmarks which can help each regulator to assess how its standards and practices compare with best practices and to adopt regulatory improvements.

Each of the participants in the tripartite effort agreed to examine its own practices to ensure that the best practices in the Guidances would be put into effect within its jurisdiction. They also specifically agreed that they would seek "the removal of domestic legal or other barriers to ensure, consistent with the regulatory framework of each jurisdiction, access by market authorities to information that permits them to detect and to deter abusive practices and disorderly conditions in the markets, including access to information that permits them to identify concentrations of positions and the overall composition of the market."⁶⁰

During the course of the year-long work program, the participants in the tripartite effort realized that certain regulators of commodity derivatives markets were precluded by the terms of the Boca Declaration from becoming signatories because they did not regulate financial futures and/or were not members of IOSCO. For example, the Japanese ministries involved in the tripartite effort were not eligible to become signatories. The participants agreed that the Boca Declaration should be amended to allow such authorities to become signatories. It was also agreed that participants would raise with IOSCO whether such authorities could become associate members of IOSCO and thus participate in its activities.

⁶⁰ *Id.* at 9.

The participants agreed to establish and maintain an emergency contact list for information sharing of surveillance and delivery information during significant market events or problems with firms. The participants endorsed the IOSCO effort to categorize and prioritize information to be shared during specific market events, which resulted in the IOSCO publication entitled *Guidance on Information Sharing* (November 1997).⁶¹ It was also agreed that the survey information reported in IOSCO's publication, *International Regulation of Derivative Markets, Products and Financial Intermediaries*,⁶² should be kept current and up to date.

The participants agreed that future efforts were needed. First, they agreed to consider amendment of the Boca Declaration to extend its application to information sharing concerning manipulative activities and unusual price movements. Second they decided to refer to IOSCO a number of matters, including the extent to which the two Guidances could be applied to financial and other derivatives markets as well as to physical commodity markets, the need for further guidance on the components of market surveillance, and further delineation of manipulative activities and abusive practices in commodity futures markets.

The actions adopted in the Tokyo Communiqué set out clear standards for ongoing international regulatory cooperation and for appropriate oversight of contract development and market activity in commodity futures markets. The Guidances provide for the first time useful international benchmarks for the supervision of commodity derivatives markets and underscore the importance of detecting and deterring manipulative activities such as those engaged in by Sumitomo. The consensus on the need for information concerning large positions on exchange markets and related cash and OTC markets was a significant step forward in enhancing the international standards of regulation of these markets, particularly in light of the participants' commitment to work to alter their domestic laws in order to implement the provision. Furthermore, the recognition of the importance of sharing such information as part of an international effort to detect broad-based manipulation efforts in their incipency represents substantial progress toward protecting the integrity of the global marketplace.

These measures addressed many of the problems demonstrated by the Sumitomo crisis: the importance of deterring manipulative schemes by careful contract design, the importance of gathering trader position and market concentration information in detecting such schemes, and the importance of sharing such information with other affected countries so that the scope and nature of the schemes can be identified.

⁶¹ IOSCO Technical Committee, *Guidance on Information Sharing* (November 1997), available at http://www.iosco.org/docs-public/1998guidance_information_sharing_document02.html.

⁶² See http://www.isoco.org/docs-public/download_1996-regulation_of_derivative_markets.html.

E. Amendments to the Boca Declaration

Pursuant to the recommendation of the Tokyo Communiqué, the Boca Declaration was amended so as to permit commodity derivatives regulators to become signatories, and both MITI and MAFF signed the Boca Declaration in October 1997.⁶³ Six additional signatories to the Boca Declaration had signed on earlier in the year,⁶⁴ and three additional regulatory authorities joined in late 1997 subsequent to the removal of the restrictive membership requirements.⁶⁵ This amendment ensured that the Boca Declaration would be available to the regulators most likely to need information on manipulative schemes.

Furthermore, the Boca Declaration was amended in March 1998 specifically to address and authorize information sharing relating to potential manipulative or abusive practices triggered by price distortions or other indications of such activities.⁶⁶ For example, such information sharing may be triggered by large price movements, unusual price relationships or the attempt by a market participant to accumulate an unusually large position.⁶⁷ These amendments to the Boca Declaration had the effect of enhancing international information sharing as it relates to commodity derivatives markets and made more effective the international efforts to detect and deter manipulation of such markets.

F. IOSCO Implementation of Recommendations of the Tripartite Conferences

At the request of the CFTC and the SIB, the IOSCO Technical Committee agreed to explore the applicability of the two Guidances adopted during the Tokyo conference of October 1997 to derivatives markets in financial instruments. At the IOSCO Annual Meeting in November 1997,

⁶³ See Press Release, Commodity Futures Trading Commission, *Commodity Derivatives Regulators Publish Guidance on Strengthening the Supervisors of International Markets*, Press Release 4072-97 (Oct. 31, 1997), available at <http://www.cftc.gov/opa/press97/opa4072-97.htm>.

⁶⁴ Regulatory authorities from Brazil, Denmark, Hungary, Malaysia, Portugal and Sweden had signed in early 1997. See Press Release, Commodity Futures Trading Commission, *Six Additional Countries Sign Declaration on Cooperation and Supervision Covering International Futures Markets*, Press Release 4003-97 (Mar. 12, 1997), available at <http://www.cftc.gov/opa/press97/opa4003-97.html>.

⁶⁵ Regulatory authorities from Argentina, Turkey and New Zealand became signatories in late 1997. See Press Release, Commodity Futures Trading Commission, *International Futures Regulators Amend Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations to Address Potential Manipulative or Abusive Practices*, Press Release 4125-98 (Mar. 20, 1998), available at <http://www.cftc.gov/opa/press98/opa4125-98.htm>.

⁶⁶ See *id.*

⁶⁷ Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organisations, as amended, available at <http://www.cftc.gov/oia/bocadec0398.htm>.

IOSCO announced that it had agreed "to further consider the extent to which the guidances developed for physical delivery commodity markets or markets with deliverables of finite supply could be extended to financial or other derivatives markets including OTC markets" and "to further develop the surveillance components addressed by the guidances by expanding upon the techniques of markets surveillance."⁶⁸

In December 1999, the Technical Committee completed its work on this subject with assistance from the CFTC and issued a report entitled *Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*.⁶⁹ The report concludes that the basic precepts of the Market Surveillance Guidance apply to derivatives on all types of commodities, but that differences in the underlying commodity and the size and composition of the market may require market authorities to place different emphasis on particular surveillance issues. Therefore, the report states that market authorities should adapt the recommendations in the Market Surveillance Guidance in certain respects in order effectively to monitor their particular derivatives markets. The report lists the types of commodities on which derivatives are currently traded and the types of abusive or manipulative practices to which such trading is subject. It concludes that surveillance depends in part on whether the derivative contract calls for delivery of a physical commodity, delivery of a financial instrument or cash settlement and suggests that contracts calling for delivery are most susceptible to manipulation when the deliverable supply of products is small relative to the positions held by traders. Pertinent surveillance issues for each type of instrument are outlined.

With respect to the Contract Design Guidance, the Technical Committee's report concludes that many issues in the design of commodity futures contracts are generic to all derivatives contracts so that the basic tenets of the Contract Design Guidance are equally useful to all types of exchange-traded derivatives contracts. However, here too the Technical Committee recommends that market authorities may need to place different emphasis on particular issues depending on the nature of the underlying commodity and the nature of the cash market. The report confirms that contract design standards are intended to ensure that contracts are not readily susceptible to manipulation, that the delivery and/or settlement mechanism is reliable and that the prices of the underlying commodity and the derivatives contract converge at the expiration of the derivatives contract so that the contract can perform a hedging function. It also states that contract design standards are a necessary complement to market surveillance.

⁶⁸ See IOSCO Technical Committee Report, *Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, (Dec. 1999) at 1-2, available at http://www.iosco.org/docs-public/1998-exchange_traded_derivatives_document02.html.

⁶⁹ *Id.*

In addition, the report focuses on international information sharing mechanisms to maintain market integrity, detect, deter and sanction potentially abusive or manipulative conduct and reduce systemic risk. It suggests that many of the elements in the Technical Committee's report on *Guidance on Information Sharing* (November 1997)⁷⁰ are applicable to international surveillance of suspected manipulation and market abuse. The report also states, "The information sharing portion of the [Market] Surveillance Guidance recommends that market authorities should be able to access sufficient information about on-exchange and related cash and OTC positions to identify dangerous concentrations of positions, to evaluate the overall composition of the market and to assess its functioning. This information is important irrespective of the nature of the underlying reference price. Knowing the whole position of a market participant in related exchange, cash and OTC markets generally is necessary to assess appropriately the risk of the participant's position and the nature of that participant's trading strategies."⁷¹ The report concludes that all of the information sharing standards in the Market Surveillance Guidance are applicable to financial derivatives contracts. In this manner, IOSCO's Technical Committee endorsed the two Guidances and broadened their applicability to include all derivatives instruments, thus extending a number of best practice standards to derivatives generally.

At the CFTC's initiative, IOSCO interpreted its membership criteria in November 1997 so as to allow commodity futures regulators to become associate members. As a result, MITI and MAFF both became members of IOSCO in November 1997. This action ensures that the regulators of important commodity markets can participate fully in the ongoing development of global regulatory standards through the auspices of IOSCO.

V. THE COLLAPSE OF LONG-TERM CAPITAL MANAGEMENT, L.P.

Long-Term Capital Management, L.P. ("LTCM"), a company located in Greenwich, Connecticut, was the operator of several very large hedge funds, speculative investment vehicles for large institutions and very wealthy investors.⁷² Its largest fund was very profitable and well capital-

⁷⁰ IOSCO Technical Committee, *supra* note 61.

⁷¹ See IOSCO Technical Committee Report, *supra* note 68.

⁷² For detailed descriptions of the LTCM episode, see HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT-REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (Apr. 1999), available at <http://www.ustreas.gov/press/releases/docs/hedgefund.pdf>; GAO, Long-Term Capital Management-Regulators Need to Focus Greater Attention on Systemic Risk (Oct. 1999); Testimony of the Commodity Futures Trading Commission before the United States Senate Committee on Agriculture, Nutrition and Forestry (Dec. 16, 1998); Daniel R. Fischell and Randal C. Picker, *Manager's Journal: A Firm That Failed Well*, WALL ST. J., Oct. 12, 1998, at A18; Michael Siconolfi, Anita Raghavan and Matt Murray, *Hedge Fund's Bailout Money Is Going Fast*, WALL ST. J., Oct. 9, 1998, at C1.

ized through 1997. At year-end 1997, this fund had more than \$4.6 billion in capital and net annual income of about \$1.4 billion. However, by September 1998, because of enormous market losses, LTCM's fund's capital had dipped well below \$1 billion, and the fund was in serious financial difficulty. Prior to its financial difficulties and based on the reputation of its principals, which included Nobel Prize winners, and its history of profitable trading, LTCM had been able to leverage the fund's capital to invest in securities valued at about \$125 billion and had entered into derivatives contracts with a notional amount of about \$1.25 trillion. Most of these derivatives were OTC transactions while the rest consisted of exchange-traded futures on domestic and foreign exchanges.

Because of the scope of LTCM's investments, the prospect of a default on its obligations threatened global economic stability. As stated by Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, "It was the judgment of officials at the Federal Reserve Bank of New York, who were monitoring the situation on an ongoing basis, that the act of unwinding LTCM's portfolio in a forced liquidation would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM."⁷³

Because of concern that LTCM was about to default on margin calls on its derivatives positions and other loans, the Federal Reserve Bank of New York facilitated a meeting of LTCM's major creditors and OTC derivatives counterparties – some of the largest U.S. and European commercial banks and investment banks. As a result, the group contributed more than \$3.6 billion in capital to LTCM's largest fund in return for a 90% ownership in it. This infusion of capital prevented LTCM's collapse and averted a significant threat to the global economy. Again, for the third time in a four-year period, a large institution's enormous losses in derivatives transactions had endangered the world economy.

A. Efforts to Contain the U.S. Impact

As noted above, the Federal Reserve System was primarily responsible for containing the LTCM crisis, and the U.S. Department of the Treasury and the SEC were also significantly involved in doing so. The CFTC's domestic efforts complemented and supplemented the actions of these other federal financial regulators.

⁷³ *Hedge Fund Operations: Hearing Before the House Comm. On Agriculture, Nutrition, and Forestry*, 105th Cong. 5 (1998) (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

On Wednesday, September 23, 1998, the Department of Treasury informed the CFTC that LTCM was in serious financial difficulties.⁷⁴ Through the CFTC's large trader reporting system,⁷⁵ the CFTC staff quickly determined the nature and value of the positions LTCM's hedge funds held on U.S. futures exchanges and took steps to identify and address any dangers to the exchanges and their clearinghouses resulting from LTCM's problems. The staff determined that LTCM had promptly and fully paid all margin obligations on its funds' futures positions on U.S. exchanges and that LTCM's funds' positions on those exchanges were cleared by two well-capitalized FCMs, Bear Stearns and Merrill Lynch, which were responsible for margin payments to the exchange clearinghouses on the LTCM funds' accounts.

The CFTC immediately contacted senior officials of the U.S. futures exchanges on which LTCM's funds held large positions to warn them of a potential default. The CFTC also alerted certain foreign regulatory authorities to large positions of LTCM's funds on their derivatives markets. Because these foreign regulatory authorities did not have access to large position information about their own derivatives markets, it was vitally important for the CFTC to provide them with information about these large positions and to warn them of the potential of a default.

Later that day, the bail out of LTCM occurred, and the danger of a default on its obligations in the U.S. and abroad was averted. Because LTCM acted as the operator of several hedge funds that were trading futures and option contracts on futures exchanges, it was required to register as a commodity pool operator ("CPO") with the CFTC and the NFA.⁷⁶ While the CFTC had no prudential supervisory role with respect to LTCM, it did have a responsibility to try to contain the danger to U.S. futures markets from LTCM's financial difficulties. For that reason, the CFTC promptly sent audit staff to LTCM to conduct a review and also to Bear Stearns and Merrill Lynch to inspect LTCM's accounts. The staff also contacted the NFA and coordinated with the NFA in reviewing LTCM's financial condition. After the LTCM bail-out, the staff continued to monitor the situation closely and to verify that LTCM and its clearing FCMs were meeting their margin requirements on U.S. futures exchanges.

While the CFTC had information about the positions of LTCM and other large hedge funds in exchange-traded futures and options, it had no information concerning OTC derivatives positions, for which there are no reporting requirements. Because many institutions were being placed at

⁷⁴ The actions of the CFTC in response to the LTCM crisis are described in Testimony of the Commodity Futures Trading Commission Before the United States Senate Committee on Agriculture, Nutrition and Forestry, *supra* note 72.

⁷⁵ See 17 C.F.R. §§ 15.00, 15.03, 17.00, 18.00 (2000).

⁷⁶ See Commodity Exchange Act, §§ 4m, 4n, 7 U.S.C. §§ 6m, 6n; 17 C.F.R. Part 4 (2000).

risk by the market volatility in the fall of 1998, the CFTC staff took steps to try to identify other traders whose position in the OTC derivatives market might affect U.S. regulated markets or financial stability. The staff contacted the CPOs of certain hedge funds that reportedly had suffered large losses and collected and analyzed detailed financial information from a number of other CPOs of large funds. The CFTC also requested information from certain FCMs concerning customers or counterparties with large positions in the OTC derivatives market which might pose significant risks and alerted FCMs, U.S. futures exchanges and the NFA to ensure that they paid particular attention to those issues. The CFTC also conducted an investigation to ascertain whether any federal commodities laws had been violated and examined the commodities laws and the CFTC's regulations to determine whether they were sufficient and whether the CFTC should amend its regulations to require heightened reporting from CPOs.

In analyzing the LTCM crisis, the CFTC identified a number of important regulatory concerns relating to hedge funds and to the OTC derivatives market: lack of transparency, excessive leverage, insufficient prudential controls, and a need for greater international cooperation and coordination.⁷⁷ The LTCM crisis demonstrated that these concerns had not been adequately addressed in the domestic and international responses to the Barings and Sumitomo crises.

1. Lack of Transparency

Although detailed information on large exchange-traded futures and option positions is reported to the CFTC daily, no reporting requirements are imposed on most OTC derivatives market participants. This lack of basic information about the positions held by OTC derivatives market participants, the nature of their investment strategies and the extent of their risk exposures potentially allows them to take positions that may threaten the regulated markets without the knowledge of any federal regulatory authority. As the Guidance on Market Surveillance recognized, derivatives regulators need information about traders' positions on the OTC and cash markets as well as on exchange markets.

2. Excessive Leverage

While traders on futures exchanges must post margin and have their positions marked to market on at least a daily basis, no such requirements exist in the OTC derivatives market, permitting entities like LTCM to become highly leveraged. Unlimited borrowing in the OTC derivatives market poses potentially serious dangers to the economy.

⁷⁷ See Testimony of the Commodity Futures Trading Commission Before the United States Senate Committee on Agriculture, Nutrition and Forestry, *supra* note 72.

3. *Insufficient Prudential Controls*

Closely related to the issue of excessive lending to LTCM is the apparent insufficiency of the internal controls applied by LTCM and its lenders and counterparties. The prudential controls of LTCM's OTC derivatives counterparties and creditors, the parties that seemingly had the greatest self-interest in assessing LTCM's financial wherewithal, apparently failed. They reportedly were unaware of LTCM's extensive borrowings and risk exposures.

4. *Cooperation Among International Regulators*

The CFTC determined that the LTCM situation demonstrated the need to continue its work with foreign derivatives regulators to ensure effective worldwide oversight of hedge funds and other large users of OTC derivatives.

B. Report of the President's Working Group on Financial Markets

In light of the LTCM incident, the President's Working Group on Financial Markets, consisting of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the SEC and the CFTC, undertook a study on hedge funds and the dangers they pose to the financial markets. The President's Working Group issued its report entitled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* in April 1999.⁷⁸ The report identifies as a central issue excessive leverage in the market and lack of information about it. The report provides important recommendations about each of the four main issues raised by the near collapse of LTCM and identified by the CFTC: the need for increased transparency; the need to eliminate excessive leverage; the need for better prudential controls; and the need for enhanced international cooperation and harmonization of regulation.

The report recognizes the critical importance of heightened transparency in the markets by recommending greater disclosure and reporting by hedge funds. It calls for all hedge funds to report detailed financial information, including information about their exposure to market risk, on a quarterly basis. This information would be provided not only to regulators but also to the public. It would thus be available to hedge fund investors, counterparties and creditors to assess the creditworthiness of the hedge fund. It would also be available to regulators and market participants to help assess market integrity and financial stability. In addition, the report recommends that all public companies should be required publicly to report their exposure to highly leveraged financial institutions.

⁷⁸ HEDGE FUNDS, LEVERAGE AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT—REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (Apr. 1999), *supra* note 72.

The report also emphasizes the need for enhanced risk management efforts by regulated entities and enhanced oversight of those efforts by regulators. It endorses the view that prudential supervisors and regulators should promote the development of more risk-sensitive approaches to capital adequacy. It also encourages private groups, such as the Counterparty Risk Management Policy Group and large hedge funds, to adopt standards for enhanced risk management.⁷⁹ In addition, the report recommends that regulators should have expanded risk assessment powers relating to unregulated affiliates of securities broker-dealers and FCMs. It reaffirms support for the President's Working Group's legislative proposal on financial contract netting upon insolvency. Finally, the report recognizes the need for international cooperation among regulators to encourage the adoption and implementation of international standards governing hedge funds and credit exposure to them in light of the large number of hedge funds operating abroad and their international market participation. The President's Working Group also agreed that, if these measures should prove to be inadequate, serious consideration should be given to the direct regulation of hedge funds and other highly leveraged institutions, including such measures as capital requirements.⁸⁰

C. IOSCO Actions

At the request of the CFTC, the IOSCO Technical Committee established a task force in December 1998 to determine what measures might be advisable to reduce the systemic risk and market stability concerns raised by the activities of highly leveraged institutions such as LTCM. The Technical Committee released its report entitled *Hedge Funds and Other Highly Leveraged Institutions* on November 5, 1999.⁸¹ The report finds that the dangers of systemic risk posed by highly leveraged institutions require great vigilance on the part of securities and derivatives firms which act as their counterparties. Prudential controls and risk management tools are ex-

⁷⁹ In response, a number of private groups have issued reports relating to the LTCM matter and the steps private firms should take more effectively to contain risk. See, e.g., *Sound Practices for Hedge Fund Managers* (Feb. 2000) (prepared by a group of large hedge fund managers); available at <http://www.hfmsoundpractices.com/hfmsp.html>; Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices* (Main report) (June 1999), available at <http://www.cmpolicygroup.org>; Managed Funds Association, *Hedge Funds: Issues for Public Policy Makers* (Apr. 1999), available at <http://www.mfainfo.org/washington/hedgefunds/hedgefunds.html>.

⁸⁰ The General Accounting Office conducted an investigation of LTCM and concluded that U.S. federal financial regulators and supervisors relied too heavily on the risk management efforts of LTCM's regulated counterparties and "did not sufficiently consider systemic threats that can arise from unregulated entities, such as LTCM." GAO, *Long-Term Capital Management - Regulators Need to Focus Greater Attention on Systemic Risk* 3 (Oct. 1999).

⁸¹ IOSCO Technical Committee, *Hedge Funds and Other Highly Leveraged Institutions* (Nov. 1999), available at <http://www.iosco.org/press/presscomm991105.html>.

tremely important for such firms, and regulatory incentives to promote improvement in risk management by securities and derivatives firms are necessary.

The report also contains recommendations regarding the need for additional transparency regarding the activities of highly leveraged institutions, noting that insufficient information is generated by the information flow from such institutions to their regulated counterparties. The report recommends that additional transparency be achieved through disclosure to the public of the activities of highly leveraged institutions, although it recognizes that reports to regulators and/or market authorities might also be helpful. The report recognizes that it is likely to be necessary to require highly leveraged institutions to provide information directly and recommends that, at a minimum, voluntary provision of such information should be encouraged.⁸²

Ideally, to address the dangers exposed by the LTCM incident, harmonized international standards relating to position reporting by hedge funds and other highly leveraged institutions should be adopted by major market jurisdictions around the globe. Such international action would be the best answer to the frequently heard argument that any domestic regulation of such institutions will drive them off shore. Global cooperation is essential to avoid a race to the bottom in which individual regulatory authorities are afraid to adopt modest protective measures for fear of placing their domestic markets at a competitive disadvantage. The adoption of widely accepted best practice standards relating to such entities would be a significant step toward protecting the world's economy from repetitions of the LTCM incident.

The LTCM incident did not cause a global financial melt-down because LTCM went to the Federal Reserve Bank of New York about its financial problems, the Federal Reserve Bank acted promptly and decisively, and LTCM's creditors and counterparties were willing swiftly to take on the responsibility of LTCM's losses. Next time we may not be as fortunate. It is vitally important, therefore, to institutionalize international protections against another similar episode.

⁸² A large number of other international organizations have considered the concerns raised by the LTCM matter, including the G7, the G22, the Bank for International Settlements, the Basle Committee on Banking Supervision, the Financial Stability Forum, the World Bank and the International Monetary Fund. See, e.g., Press Release, Financial Stability Forum, *Financial Stability Forum endorses policy actions aimed at reducing global financial vulnerabilities, Report of the Working Group on Highly Leveraged Institutions (HLIs)* (Mar. 26, 2000), available at <http://www.fsforum.org/Reports/RepHLI.html>; International Monetary Fund, *Hedge Funds and Financial Market Dynamics*, Occasional Paper 166 (May 1998), available at <http://www.imf.org/external/pubs/cat/longres.cfm?sk&sk=2597.0>; *Report of the G-22 Working Group on Transparency and Accountability* (Oct. 1998); *Declaration of G7 Finance Ministers and Central Bank Governors*, U.S. Department of Treasury, RR-2792 (Oct. 30, 1998), available at <http://www.ustreas.gov/press/releases/pr2792.htm>.

VI. CONCLUSION

The CFTC's efforts and those of other international derivatives regulators have led to an increased level of international communication and cooperation, growing consensus on the standards for regulation of derivatives markets and a trend toward international regulatory convergence. These actions have created a framework that will enable international regulators to deal more effectively with future crises in these markets. However, more work needs to be done. Implementation of the reforms necessitated by the Barings, Sumitomo and LTCM crises is still underway, and future crises will undoubtedly lead to additional regulatory improvements.

Moreover, the multinational participants in the derivatives markets require and deserve a higher degree of international regulatory harmonization to facilitate their business operations and to reduce the burdens of conforming to many different national regulatory schemes. International regulators have a responsibility not only to streamline and modernize domestic regulatory programs but also actively to pursue the elimination of unnecessary regulatory divergence on an international level. With the continuing globalization of the financial markets, this must be the goal for the future.