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Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?

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Thomas C. Singher

Abstract

This note examines derivatives and derivatives related issues. In particular, it evaluates the costs and benefits of utilizing derivatives, explores the current debate over derivative regulation—both domestically and transnationally, and the role and effect of Congressional intervention in regulation.

REGULATING DERIVATIVES: DOES TRANSNATIONAL REGULATORY COOPERATION OFFER A VIABLE ALTERNATIVE TO CONGRESSIONAL ACTION?

Thomas C. Singher*

INTRODUCTION

Markets in derivative financial instruments are rapidly expanding,¹ and are currently measured in trillions of dollars.² These relatively new investment vehicles³ have provided their users with unprecedented opportunities to protect themselves against financial loss⁴ and other risks involved in conducting

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1. Barbara Donnelly Granito, *Assessing the Size of the Market*, WALL ST. J., Aug. 25, 1994, at A4. Derivatives markets are some of the fastest growing financial markets in the world. John Andrew Lindholm, *Financial Innovation and Derivatives Regulation — Minimizing Swap Credit Risk Under Title V of the Futures Trading Practices Act of 1992*, 1994 COLUM. BUS. L. REV. 73, 77 (1994).

2. *Beleaguered Giant: As Derivatives Losses Rise, Industry Fights to Avert Regulation*, WALL ST. J., Aug. 25, 1994, at A1 [hereinafter *Beleaguered Giant*]. Estimates of the size of the global derivatives markets are in the US\$10 trillion to US\$35 trillion range. *Id.* The U.S. General Accounting Office, at US\$12.1 trillion in 1992, offers a more conservative albeit less current estimate of the size of the global derivatives markets. U. S. GENERAL ACCOUNTING OFFICE, PUB. NO. B-257099, GAO REPORT 3 (1994) [hereinafter GAO REPORT]; see Eli M. Remolona, *The Recent Growth of Financial Derivative Markets*, 28 FED. RES. BANK N.Y. Q. REV. 28, 28-29 (1993) (estimating size of global derivatives markets to be US\$10 trillion at end of 1991). For a general discussion of the market shares occupied by various types of derivatives in global markets, see Barbara Donnelly Granito, *Assessing Size of Market*, WALL ST. J., Aug. 25, 1994, at A4; Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 AM. U. L. REV. 1023, 1030 (1994) (discussing size of over-the-counter markets in comparison to exchange traded derivatives).

3. Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1 (1994). Although modern derivatives markets have only appeared in approximately the last ten years, historians are able to trace derivative-like transactions back to 2000 B.C. *Id.*; see EDWARD J. SWAN, THE DEVELOPMENT OF THE LAW OF FINANCIAL SERVICES 2 (1993) (discussing Mesopotamian commodities contracts possessing characteristics similar to modern derivatives). Roman law, although maintaining an aversion to futures contracts, did recognize such contracts. *Id.* at 30-33. A crude form of a derivative financial instrument appeared in the United States during the mid- to early eighteenth century when the State of Massachusetts Bay issued notes that were to be paid in an amount calculated in correlation with fluctuating prices of corn, beef, sheeps wool, and sole leather. WILLIAM G. ANDERSON, THE PRICE OF LIBERTY: THE PUBLIC DEBT OF THE AMERICAN REVOLUTION 24 (1983).

4. PAUL GORIS, THE LEGAL ASPECT OF SWAPS AN ANALYSIS BASED ON ECONOMIC SUBSTANCE 45, 46 (1994); see Lindholm, *supra* note 1, at 84 (describing derivatives as they are used to hedge against changing market factors).

business across national borders.⁵ These opportunities have been accompanied, however, by new financial risks,⁶ and many derivatives users have suffered large financial losses.⁷ Market regulators and Congress have quickly responded to the perceived derivatives threats by introducing new rules and proposed legislation.⁸

Derivatives losses and the subject of how to regulate derivatives markets has been a focus of attention in the U.S. Congress ("Congress").⁹ Senators and House Representatives have debated the merits and dangers presented by the current regula-

5. Waldman, *supra* note 2, at 1030. Multinational corporations, for instance, utilize derivative financial instruments to offset the risk that currency fluctuations will adversely affect their financial interests across national borders. *Id.*

6. Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1465-66 (1993); see Waldman, *supra* note 2, at 1038-50 (separating risks accompanying derivatives into six general categories).

7. *\$1.5 Billion Loss Seen For County*, N.Y. TIMES, Dec. 2, 1994, at D1. The largest and most recognized loss to date is that incurred by Orange County, California. Mark Platte et al., *O.C. to Liquidate its Portfolio*, L.A. TIMES, Dec. 14, 1994, at A1. Analysts originally projected the loss to be near US\$1.5 billion but have now revised that figure to US\$2.02 billion or 27% of a US\$7.4 billion investment made by the county in an investment pool utilizing derivatives. *Id.* The county subsequently filed for bankruptcy protection in the largest such filing by a municipality on record. *Bitter Fruit: Orange County, Mired In Investment Mess, Files for Bankruptcy Decision, Following Default on Reverse-Repo Deals, May Put Assets in Limbo*, WALL ST. J., Dec. 7, 1994, at A1. For an exhaustive collection of derivative-related losses, see Waldman, *supra* note 2, at 1039-41.

Losing investors, meanwhile, have been quick to seek redress in court. Karen Donovan, *Derivatives Slump: Losers Go to Court Lawsuits Over Exotic Securities May Bind Banks Closer to Clients*, NAT'L L. J., Nov., 1994, at A1. Both Gibson Greetings Inc. and Procter & Gamble Company filed suits against Bankers Trust seeking US\$73 million and US\$130 million for damages incurred from their respective losses of US\$23 million and US\$157 million. Michael Quint, *Gibson Suit On Trades Is Settled*, N.Y. TIMES, Nov. 24, 1994, at D1. The losses were alleged to have occurred as a result of investment guidance provided by Bankers Trust. *Id.* Gibson later dropped the suit against Bankers Trust in exchange for forgiveness of US\$14.5 million in debt Gibson owed to Bankers Trust. *Id.* Another example of a losing investor taking action is that of Winifred Emmeline Vandyke, who filed a federal class action against Fundamental Family of Funds alleging that the fund failed to tell investors the true nature of risks involved in its derivatives. David E. Rovella, *Derivatives Sales Draw Class Action Plaintiff Says Funds Group Misled Investors on Risks*, NAT'L L. J., Aug. 29, 1994, at B1; see Karen Donovan; Leslie Wayne, *Orange County in Suit Against Merrill Lynch*, N.Y. TIMES, Jan. 13, 1995, at D2 (discussing Orange County's suit against Merrill Lynch contending that brokerage firm sold risky and unsuitable securities to Orange County in violation of California Law).

8. Roger M. Zaitzeff, *Pending Legislation Would Require Regulators to Monitor More Closely The Complex Range of Activities in the Derivatives Market*, NAT'L L.J., Aug. 29, 1994, at B9.

9. Zaitzeff, *supra* note 8, at B9.

tory influences governing derivatives.¹⁰ Some have argued that the current regulatory system is sufficient to deal with the dangers derivatives present,¹¹ while others have disagreed, calling for new derivatives-governing legislation.¹² As financial losses have persisted, pro-legislation Congressmen have promised further debate.¹³

This Note examines derivatives and derivatives-related issues. Part I describes derivative financial instruments, their benefits and risks, and the parties that typically utilize them. Part I also delineates the general regulatory framework that currently governs derivatives and examines losses that have occurred under that framework. Part II describes the current debate as to how to regulate derivatives, specifically examining five proposed

10. *Id.*

11. Olaf De Senerpont Domis, *D'Amato: No Need for Derivatives Legislation*, AM. BANKER, Jan. 6, 1995, at 1.

12. Zaitzeff, *supra* note 8, at B9. Chairman of the House Banking, Finance and Urban Affairs Committee, Congressman Henry B. Gonzales [R-Texas], has described the derivatives market as a transnational ponzi scheme. *Derivatives Update—Further Losses Will Make Legislation More Likely*, INT'L BANKING REG., Oct 10, 1994 at 1. Senator and member of Alfonse M. D'Amato [R-N.Y.] expresses his concern with derivatives markets in stating "I don't want to have a situation where we have a debacle where we wind up one morning reading that we've got a US\$2 billion or US\$3 billion loss in some institution as a result of highly leveraged transactions within the banks." De Senerpont Domis, *supra* note 11, at 1. House Representative and member of the House Banking, Finance and Urban Affairs Committee, James A. Leach [R-Iowa], noted that "[t]he sheer size of the [derivatives] market implies that it cannot be ignored." Michael Peltz, *Congress's Lame Assault on Derivatives*, INSTITUTIONAL INVESTOR, Dec. 1994, at 65. Leach has described the most worrisome aspect of derivatives to be "the fact that much of the underpinnings of the trillion-dollar-a-day global derivatives market is rampant speculation and gambling." *Id.* House Representatives Jim Leach and Henry Gonzalez have both submitted legislation modifying the current supervisory framework governing derivatives. H.R. 31, 104th Cong., 1st Sess. (1995); H.R. 20, 104th Cong., 1st Sess. (1995). House Representative Edward J. Markey [D-Mass.] has also introduced legislation that would regulate unregulated derivatives dealers. H.R. 4745, 103d Cong., 2d Sess. (1994). Similarly in the Senate, Senators Byron L. Dorgan [D-N.D.] and Barbara A. Mikulski [D-Md.] have submitted a bill that would limit banks to using derivatives for hedging purposes as opposed to speculative purposes. S. 2123, 103d Cong., 2d Sess. (1994). The now former chairman of the Senate Committee on Banking, Housing, and Urban Affairs, Donald W. Riegle Jr. [D-Mi.] also introduced a bill similar to the Gonzalez-Leach bill. S. 2291, 103d Cong., 2d Sess. (1994).

13. Joanne Morrison, *National*, BOND BUYER, Dec. 20, 1994, at 24. Representative Gonzalez, in response to the Orange County disaster, urged further Congressional hearings to discuss recent derivatives-related losses. *Id.* Representative Markey also recently promised to reintroduce derivatives legislation similar to proposals he had made previously. Dominic Bencivenga, *Congressional Agenda: Litigation Reform, Derivatives Regulation on Tap*, N.Y. L.J., Jan. 19, 1995, at 5.

congressional bills,¹⁴ and transnational efforts aimed at developing a framework for safe derivatives use. Part III argues that Congress should refrain from passing legislation governing derivatives that contravene regulatory agency and industry approval.¹⁵ This Note concludes that the current regulatory framework, as supplemented by non-congressional efforts to ameliorate unnecessary derivatives losses, is the appropriate mechanism to address derivatives-related problems.

I. *DERIVATIVE FINANCIAL INSTRUMENTS: AN OVERVIEW*

The term derivatives, in the financial context, refers to a wide variety of financial instruments.¹⁶ The purpose of a derivative financial instrument varies depending on the interests of the particular parties involved in the derivative transaction.¹⁷ Although derivatives can convey financial benefit to their users, users must be willing to withstand varying degrees of derivatives-inherent risk.¹⁸ In the United States, derivatives are also subject to various regulatory requirements depending on the nature and type of the financial instrument.¹⁹ These requirements have not, however, prohibited large derivatives-related losses.²⁰

14. See *supra* note 12 (discussing five proposed bills).

15. Kenneth H. Bacon & Greg Hiitt, *Derivatives Face New Regulation From Congress*, WALL ST. J., May 11, 1994, at A4. Regulatory bodies such as the Securities Exchange Commission ("SEC") and the Commodities Futures Trading Commission ("CFTC") have opposed attempts by the U.S. Congress to pass new derivative-governing legislation. *Id.*; see *Beleaguered Giant*, *supra* note 2, at A1 (discussing the efforts of Federal regulators, government issuers, Wall Street dealers, corporations, and mutual funds to defend derivatives and forestall new regulations).

16. GAO REPORT, *supra* note 2, at 4. Derivatives can be classified into four basic categories: "Forwards," "Futures," "Options," and "Swaps." *Id.*

17. GLOBAL DERIVATIVES STUDY GROUP, *DERIVATIVES: PRACTICES AND PRINCIPLES 28* (Group of Thirty eds. 1993) [hereinafter *GROUP OF THIRTY*] (describing various reasons why derivatives users employ investment strategies that utilize derivative financial instruments).

18. See Waldman, *supra* note 2, at 1038-50 (discussing six commonly classified risks accompanying derivatives use).

19. See Daniel P. Cunningham et al., *An Introduction to OTC Derivatives, in SWAPS AND OTHER DERIVATIVES IN 1994*, at 154-70 (PLI Corporate Law and Practice Course Handbook Series No. B4-7062, 1994) (discussing current U.S. regulatory framework governing derivatives).

20. John Greenwald, *The Devil's in the Derivatives; Exotic Securities Spread Financial Wreckage Across the Country in the Wake of Interest-Rate Hikes*, TIME, Oct. 10, 1994, at 54.

A. Defining the Derivative Financial Instrument

A derivative financial instrument consists of a contractual agreement between two or more parties.²¹ The agreement, which usually obligates the parties to exchange specified cash payments, has a value to the parties and also an independent value on an open market.²² The value of the agreement on the open market depends upon the value of the underlying payments.²³ The value of the underlying payments in turn, are connected to the performance of named assets, rates, or indexes, depending upon the terms of the derivatives contract.²⁴ Thus, as the value of the contractual payments rises or falls depending upon the value of the underlying asset, rate, or index, so too does the value of the derivatives contract.²⁵

Derivatives come in many shapes and sizes,²⁶ ranging from standardized exchange traded contracts²⁷ to privately negotiated

21. GROUP OF THIRTY, *supra* note 17, at 28. A study of derivatives conducted by an international task force set up by the global banking industry defined derivative transaction as "a bilateral contract or payments exchange agreement whose value derives . . . from the value of an underlying asset or underlying reference rate or index." *Id.* Another commentator simply defined derivatives as "paper assets whose value depends on another asset." Scott T. Jones & Frank A. Felder, *Using Derivatives In Real Decision Making*, 132 PUB. UTIL. FORT. 18 (1994). Henry T.C. Hu defines a derivative as

a contract that either allows or obligates one of the parties . . . to buy or sell an asset. Naturally, movements in the value of the underlying asset affect the value of such a contract. Indeed, the contract's defining characteristic is that its value derives from the value of the 'underlying,' be it a specific stock, commodity, stock index, interest rate, or exchange rate. . . .

Hu, *supra* note 6, at 1464-65.

22. GROUP OF THIRTY, *supra* note 17, at 28.

23. *Id.*

24. *Id.*

25. See Hu, *supra* note 6, at 1465 (discussing effects of natural movements of underlying asset upon value of agreement).

26. Albert R. Karr, *Bank Regulator Signals Move On Derivatives*, WALL ST. J., May 24, 1994, at C1. The Comptroller of the Currency has found more than 1200 types of derivatives, and the financial innovators of Wall street continue to create new ones. *Id.* Derivatives descend from four basic categories, "Forwards," "Futures," "Options," and "Swaps." GAO REPORT, *supra* note 2, at 4. Forwards are subdivided into groups such as "Forward Commodity Contracts," "Forward Rate Agreements," "Forward Foreign Exchange Contracts." *Id.* Swap derivatives are classified as "Currency Swaps," "Interest Rate Swaps," "Commodity Swaps," and "Equity Swaps," while options and futures may link their value to global currencies and other commodities. *Id.* Hybrid instruments such as the "Swaption" combine characteristics of several derivatives. GROUP OF THIRTY, *supra* note 17, at 29; see Cunningham, *supra* note 19, at 127-31 (discussing particular properties of many fundamental types of derivative financial instruments).

27. Hu, *supra* note 6, at 1465. Many derivatives are traded on organized exchanges and a prospective buyer need only contact a broker to close a sale. *Id.* Such derivatives

agreements between parties tailored to the parties' specific needs.²⁸ Organized derivatives exchanges²⁹ typically trade derivatives commonly known as futures and options.³⁰ A future is a forward based contract³¹ that obligates the buyer to deliver a fixed quantity of a commodity at a fixed date and price in the future.³² Option-based derivatives, however, do not bind the buyer to do anything.³³ An option merely gives the buyer the option or right to buy or sell a particular commodity at an agreed upon price at or prior to a specified date.³⁴ Whether traded on or off organized exchanges, forward and option-based contracts form the building blocks of all derivative financial products.³⁵

generally have standardized contractual terms and generate sufficient market activity to provide for an adequately liquid market. *Id.*

28. *Id.* Privately negotiated derivatives are most likely to be used by sophisticated parties, for example, large corporations and sovereign entities. *Id.* Privately negotiated contracts compose the over-the-counter or "OTC" derivatives market. *Id.*

29. RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES & MATERIALS 7th ed. 11-16 (1992) (discussing derivative financial instruments and organizations that trade them). The Chicago Board Options Exchange ("CBOE"), inaugurated in 1973, is one example of an organized derivatives market. *Id.* at 12. The CBOE provides a central market where buyers and sellers of derivatives can trade derivatives known as options. *Id.*

30. GROUP OF THIRTY, *supra* note 17, at 29.

31. *Id.* A forward contract obligates one party to buy or sell a specified quantity of an asset at a specified price and date. *Id.* at 30. A future is a standardized forward contract where generally the price is the only open variable. *Id.*

32. *Id.*

33. *Id.* at 32.

34. *Id.* at 29.

35. *Id.*; see Clifford W. Smith, Jr. & Charles W. Smithson, *Financial Engineering: An Overview*, in THE HANDBOOK OF FINANCIAL ENGINEERING: NEW FINANCIAL PRODUCT INNOVATIONS, APPLICATIONS, AND ANALYSES 4-9 (1990) (noting that forward and option contracts serve as building blocks in derivative financial products).

A common privately negotiated derivative transaction known as the forward-based interest rate for equity swap might work as follows. Craig Torres, *How a Simple Derivatives Deal Works*, WALL ST. J., Aug. 17, 1993, at A8. A money manager in the United States could, for instance, arrange for a client to swap a contractual agreement to make payment amounts based on a particular interest rate, for similar payments based on a stock-market return. *Id.* The money manager might first invest for example, US\$30 million of the client's funds in short-term notes at a yield slightly over the commonly used London Interbank Offered Rate ("LIBOR"). *Id.* Subsequently, the money manager would negotiate a swap with another party who possesses what the manager determines to be an adequate credit-rating. *Id.* The swap could be an agreement between the manager's client and the creditworthy party whereby the client pays the bank a rate equal to the LIBOR plus a small percentage. *Id.* In exchange, the creditworthy party might pay the client the return on the Standard & Poor 500-stock index. *Id.* If the creditworthy party were a bank, for example, it could realize a profit on the transaction

B. Derivatives Users

A wide variety of entities participate in today's derivative markets.³⁶ The participants are separable into end-users and dealers.³⁷ The end-user is generally the party that initially seeks to enter into the contract, and that ultimately is obligated to buy or sell an asset.³⁸ The dealer, in contrast, is merely an intermediary who facilitates the transaction in exchange for some form of financial gain.³⁹

The end-user class consists mostly of corporations, governmental entities,⁴⁰ institutional investors,⁴¹ and financial institutions.⁴² Occasionally smaller and less sophisticated investors enter into derivatives transactions.⁴³ When such transactions oc-

by executing a similar transaction with another party possessing opposite commitments (the bank would pay amounts based on the LIBOR while collecting payments based on the S&P index). *Id.* The bank thus realizes as profit, the small premium paid over the LIBOR minus the transaction costs of executing the second transaction. *Id.* The client, meanwhile, earns the difference between the rate of return on the notes and the rate it agreed to pay the bank, plus, the return on the S&P index. *Id.*

Some of today's computer engineered financial products are much more complex than this example. See Steven Lipin & William Power, *Derivatives Draw Warning From Regulator*, WALL ST. J., Mar. 25, 1992, at C1 (noting regulator's concern that derivatives complexity may be so high that neither regulators nor derivatives traders understand them).

36. GROUP OF THIRTY *supra* note 17, at 34.

37. *Id.*

38. Hu, *supra* note 6, at 1465.

39. Waldman, *supra* note 2, at 1036. Dealers may realize a financial gain in the form of a transaction fee. *Id.* Dealers may alternatively realize financial gain in the form of "bid-offer spreads." *Id.* The bid-offer spread is the difference between the bidding and offering price of the financial instrument. GARY L. GASTINEAU, *DICTIONARY OF FINANCIAL MANAGEMENT* 37 (1992). In the OTC market, dealers serve the important purpose of making a market in OTC derivatives. Waldman, *supra* note 2, at 1036.

40. GROUP OF THIRTY, *supra* note 17, at 38. National governments, local governments, and state-owned or sponsored entities, all utilize derivatives. *Id.* The governmental end-user class, is not limited to large entities such as states and federal agencies. Waldman, *supra* note 2, at 1034-35. Even small town municipalities have found uses for derivatives. *Id.*

41. *Id.* at 40. Some examples of institutional investors that utilize derivatives are Salli Mae, Sohio, and General Electric Capital Corporation. *Id.*

42. *Id.* at 34. A Survey of Industry Practice conducted by the GROUP OF THIRTY, a transnational organization of prominent banking and individuals involved in financial markets, indicates that "[r]oughly 87% of the reporting private sector corporations use interest rate swaps, 64% use currency swaps, and 78% use forward foreign exchange contracts. *Id.* For option-based derivatives, 40% use interest rate options and 31% use currency options." *Id.* at 34; see GLOBAL DERIVATIVES STUDY GROUP, *DERIVATIVES: PRACTICES AND PRINCIPLES 1* (Group of Thirty eds. 1993) (App. III: Survey of Industry Practice) (1994) [hereinafter GROUP OF THIRTY SURVEY].

43. Hu, *supra* note 6, at 1465. Generally the OTC market is only open to large

cur in the over-the-counter market,⁴⁴ they have drawn concern.⁴⁵ Due to the involvement of derivatives in mutual funds, insurance companies, pension funds, and governmental entities, one commentator stated that the investment mainstream has indirectly become a collective end-user.⁴⁶

In contrast to a somewhat diverse end-user class, the dealer class largely consists of banks and securities firms.⁴⁷ Less frequently, insurance companies and highly-rated corporations also deal in derivatives.⁴⁸ Maintaining the position of dealer requires substantial capital and credit appraisal experience, modern technology, financial expertise, and excellent credit standing.⁴⁹ Once in possession of the appropriate assets, the dealer is then able to access broad markets while maintaining the ability to quickly process information those markets provide.⁵⁰ A typical dealer maintains a portfolio of derivatives that allows him to accommodate a broad variety of customer transactions.⁵¹ Upon ex-

sophisticated end-users who have the clout to negotiate directly with finance divisions of industrial corporations, financial institutions, or money center banks. *Id.* *But see* Salomon Forex v. Tauber, 795 F.Supp. 768, 769 (E.D. Va. 1993), *aff'd*, Salomon Forex, Inc. v. Tauber, 8 F.3d 966 (4th Cir. 1993), *cert. denied*, 114 S.Ct. 1540 (1994) (holding non-U.S. currency exchange contracts between Mr. Tauber, doctor and real estate investor, and Salomon Forex, Inc., large non-U.S. currency exchange company, unenforceable under Commodities Exchange Act).

44. JENNINGS, *supra* note 29, at 62. The over-the-counter or "OTC" market, trades an estimated 20,000 securities that are not listed on other organized exchanges. *Id.* The OTC market has no physical location and there are no formalized procedures for commencing or terminating transactions in a particular security. *Id.*

45. Waldman, *supra* note 2, at 1035. Some commentators fear that unsophisticated investors involved in the OTC market will suffer from the absence of protection afforded by suitability rules found on exchanges:

[c]urrently, there is no requirement that an OTC derivative instrument be 'suitable' for the need of a particular end-user. In contrast, dealers of exchange-traded products are proscribed from recommending options transactions unless they have a reasonable basis for believing the customer has the knowledge and sophistication to evaluate and financially bear the transaction in question.

Id. Derivatives have also found their way into the hands of smaller investors through mutual funds. David J. Lynch, *Derivatives Get Some Money Market Funds in Trouble*, ORANGE COUNTY REG., Aug. 2, 1994, at 3E.

46. Waldman, *supra* note 2, at 1035.

47. GROUP OF THIRTY, *supra* note 17, at 34.

48. *Id.* at 34.

49. *Id.* at 42. Most dealers are financial institutions with investment grade credit ratings. *Id.*

50. *Id.*

51. *Id.* at 41. Early in the evolution of OTC derivatives, dealers acted merely as

ecuting a transaction with one end-user, a dealer will oftentimes subsequently enter into an offsetting transaction with another end-user.⁵² Thus, dealers provide valuable liquidity to derivatives markets and eliminate the need for end-users to locate one another independently.⁵³ Dealers also support price efficiency by identifying and exploiting price differences in underlying market instruments.⁵⁴ In exchange for his services, the dealer collects not only his fee for executing the transaction,⁵⁵ but also any profit realized from his own portfolio.⁵⁶

C. Why Investors Use Derivatives

Derivatives facilitate identification, isolation, and separate management of fundamental risks that are bound together in traditional financial instruments.⁵⁷ Managers of financial portfolios often take advantage of derivative financial products to achieve desired combinations of cash flow, interest rate, and currency liquidity.⁵⁸ In doing so, the manager may achieve the objectives of his client to lower funding costs,⁵⁹ better manage its assets and liabilities,⁶⁰ hedge⁶¹ against market risk, or to specu-

brokers. *Id.* They offered only limited services, such as finding offsetting counterparties for the investor. *Id.*

52. Cunningham, *supra* note 19, at 131.

53. *Id.* When purchasing an exchange-traded derivative, an end-user usually need only place a call to a broker to execute the transaction. *Id.* In contrast, the OTC market utilizes the reputation and creditworthiness of the dealer to match buyers and sellers. Hu, *supra* note 6, at 1465.

54. GROUP OF THIRTY, *supra* note 17, at 42.

55. See *supra* note 39 and accompanying text (discussing profit opportunities for dealers).

56. GROUP OF THIRTY, *supra* note 17, at 42.

57. *Id.* at 34.

58. *Id.*

59. *Id.* at 34.

60. *Id.* at 36.

61. GASTINEAU, *supra* note 39, at 123. Commentators define hedging as action that reduces risk, often in exchange for opportunity for profit. *Id.*; see PAUL GORIS, THE LEGAL ASPECT OF SWAPS: AN ANALYSIS BASED ON ECONOMIC SUBSTANCE 79 (1994) (referring to hedging transaction as transaction intended to "safeguard the contracting entity against the adverse consequences of unfavorable fluctuations in non-U.S. exchange rates, interest rate levels, or other market variables"); Federal Deposit Ins. Corp., *Derivative Product Activities of Commercial Banks*, in JOINT STUDY CONDUCTED IN RESPONSE TO QUESTIONS POSED BY SENATOR RIEGLE ON DERIVATIVE PRODUCTS 3 (1993) (describing "hedging" as acquiring position in instrument that moves opposite direction in value from existing or anticipated position with "goal of protecting that existing or anticipated position against loss due to fluctuations in prices, interest rates or exchange rates").

late for profit.⁶²

1. Using Derivatives to Lower Funding Costs

End-users often take advantage of derivatives to lower funding costs.⁶³ One way derivatives promote lower funding costs is by facilitating access to funding opportunities that exist in segmented capital markets.⁶⁴ Once an end-user is able to access those markets, principles of comparative advantage⁶⁵ may operate to deliver cost savings for borrowers and higher yields for investors than would otherwise be available.⁶⁶

For example, a corporation may desire funding in a particular currency at a lower rate than is currently available in markets using that currency.⁶⁷ The corporation may, however, find an attractive rate in a market using another currency.⁶⁸ A common derivative known as the currency swap⁶⁹ allows a corporation to take advantage of the attractive rate.⁷⁰ The corporation issues debt in the undesirable currency⁷¹ and then finds a counterparty

62. GORIS, *supra* note 4, at 82.

63. GROUP OF THIRTY, *supra* note 17, at 34; see Roger M. Zaitzeff, *Regulating Financial Derivatives*, NAT'L L.J., Aug. 29, 1994, at B9 (discussing lower cost funding as reason for derivatives' growth in popularity).

64. GROUP OF THIRTY, *supra* note 17, at 35. Regulatory barriers and different perceptions in credit quality result in segmentation of markets over both national and transnational boundaries. *Id.*

65. Cunningham, *supra* note 19, at 131-32. Through the use of derivatives, parties to a transaction are able to trade not only rates and currencies, but also any advantage that one or both parties may have in a given market. *Id.*; see Lindholm, *supra* note 1, at 81-82 (noting that swaps allow both transaction parties to reduce their funding costs).

66. GROUP OF THIRTY, *supra* note 17, at 35. When an end-user takes advantage of varying rates between different markets, it is said to be taking advantage of arbitrage opportunities between markets. *Id.* Arbitrage savings in interest rate markets for example, currently is likely to be in the range of 0.10% to 0.25%. *Id.*; see Hu, *supra* note 6, at 1466 (noting that end-users use derivatives to arbitrage price differences between capital markets).

67. See Hu, *supra* note 6, at 1466 (discussing similar example and increasing volume in swap transactions).

68. *Id.*

69. Marc A. Horwitz, *Swaps Ahoy! Should Regulators Voyage Into Unknown Waters*, 1 IND. J. GLOBAL LEGAL STUD. 515, 521 (1994). Currency swaps are one of the most widely utilized forms of derivatives today. *Id.* In a typical swap transaction, one party agrees to pay periodic fixed amounts of one currency while the other agrees to do the same in a different currency. *Id.* The transaction has the effect of transferring from one party to the other the risk of exchange rate fluctuation. *Id.*

70. *Id.*

71. *Id.*

to execute a currency swap.⁷² The counterparty agrees to periodically pay the corporation fixed amounts of its desired currency in exchange for a fixed amount of the unwanted currency.⁷³ The net result of the transaction is that the corporation has issued debt in a desired currency at a lower rate than it could have obtained in an otherwise unaccessible market.⁷⁴

End-users may also obtain lower cost funding by issuing securities specifically tailored to individual investor needs⁷⁵ or by simply taking advantage of lower transaction costs.⁷⁶ In the former case, the end-user issues securities matching the particular needs of an investor or investors and then utilizes derivative financial instruments to tailor the return on that security to meet the end-user's own needs.⁷⁷ In the case of the latter, investing in a derivative form of an asset may ultimately prove to be cheaper than investing in the underlying asset.⁷⁸ Thus, the derivative form of that asset such as a future or an option may prove to be less costly than the alternative of investing in the underlying asset.⁷⁹

Regardless of which method a corporation chooses, using derivatives to lower funding costs diversifies funding sources.⁸⁰ Diversification of funding may be important to international corporations that cannot raise capital in smaller capital markets.⁸¹ Without the existence of derivative instruments to allow the raising of capital in one market to be used in another, corporations might not be able to complete projects located in capital mar-

72. *Id.*

73. *Id.*

74. See *supra* note 66 (discussing arbitrage profits).

75. GROUP OF THIRTY, *supra* note 17, at 35.

76. See FRANK J. FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 181-82 (1992) (noting that futures markets may provide cheaper way to adjust portfolios).

77. Cunningham, *supra* note 19, at 132. For example, the corporation may use OTC derivatives to trade floating interest rate liabilities for fixed rate liabilities. *Id.* Similarly, it may trade liabilities denominated in one currency for liabilities denominated in another currency. *Id.* The resulting liability is termed a synthetic liability as, in effect, the corporation has combined several instruments to create one liability. *Id.* Corporations may likewise create synthetic assets by trading away various asset based characteristics. *Id.*

78. Hu, *supra* note 6, at 1466.

79. *Id.*

80. GROUP OF THIRTY, *supra* note 17, at 35.

81. *Id.*

kets too small to provide adequate capital.⁸²

2. Using Derivatives as an Asset and Liability Management Tool

An alternative use for derivatives is to manage existing debt or asset portfolios.⁸³ As economic prospects vary, the holder of a portfolio may desire to exchange certain characteristics of that portfolio for other more favorable characteristics.⁸⁴ For example, the portfolio of a small thrift institution may consist of short-term variable-rate liabilities,⁸⁵ and long-term, fixed-rate assets.⁸⁶ The prospect of rising interest rates may be unattractive to the thrift, as its ability to pay floating-rate liabilities from the income of fixed rate assets will diminish as interest rates rise.⁸⁷ A large commercial bank in contrast, may manage a portfolio consisting of substantial fixed-rate liabilities⁸⁸ and floating rate-assets.⁸⁹ Through the services of a dealer,⁹⁰ the two banks may execute a swap transaction whereby the thrift makes periodic fixed rate payments in exchange for periodic floating rate payments.⁹¹ As parties receive favorable characteristics in exchange for unfavorable ones, the swap results in portfolios better attuned to the needs of both parties.⁹²

3. Derivatives as a Hedging Instrument

A third common use for derivative financial instruments is to hedge⁹³ against unfavorable movements in capital mar-

82. *Id.*; see Lindholm, *supra* note 1, at 83-84 (discussing swaps as effective tools to control interest rate risk when used in asset and liability management).

83. GROUP OF THIRTY, *supra* note 17, at 36.

84. *Id.*

85. Cunningham, *supra* note 19, at 131. Variable-rate liabilities that the holder must pay in the near future, typically consist of deposits or borrowings. *Id.*

86. *Id.* Fixed-rate liabilities that the holder need not meet until a relatively distant time in the future, typically consist of mortgages. *Id.*

87. *Id.*

88. *Id.* Publicly held debt for example, might compose the fixed-rate liability of a large commercial bank. *Id.*

89. *Id.* Commercial banks typically may possess commercial loans as floating-rate assets. *Id.*

90. See *supra* note 39 and accompanying text (discussing derivatives dealers).

91. Cunningham, *supra* note 19, at 131.

92. *Id.*

93. See *supra* note 61 (defining hedging). More than 82% of the corporations responding to the Group of Thirty survey indicated that they use derivatives to hedge market risks arising from new financing. GROUP OF THIRTY SURVEY, *supra* note 42, at 36;

kets.⁹⁴ Often, end-users of derivatives face fluctuating markets that in turn cause fluctuation in the value of their assets.⁹⁵ The derivative used as a hedge provides security against risk that those fluctuations will adversely affect the end-user's financial interests.⁹⁶ The hedge participant exchanges opportunity for profit in exchange for security or protection against unwanted risk.⁹⁷ By using derivatives to hedge against market fluctuations, end-users are free to pursue their business objectives without diverting unnecessary energy to management of market concerns.⁹⁸ Hedging uses have saved companies large amounts of money⁹⁹ and promises to be popular uses for derivatives in coming years.¹⁰⁰

The popularity of derivatives as hedging instruments stems from benefits derived from transactions such as the following. An end-user satisfying large short-term cash requirements with short-term floating-rate borrowings might desire to control its interest rate risk.¹⁰¹ By ensuring a stable interest rate, the end-user

see supra note 1, at 84 (noting that borrowers may use swaps to hedge against changes in interest rates occurring months or even years away).

94. *GORIS, supra* note 4, at 45-46. The interest rate and currency swap, two instruments that are now used for a variety of purposes, were originally introduced during the 1980's as hedging instruments to control unpredictable non-U.S. exchange and interest rate fluctuations. *Id.* The new risk-hedging devices that which had been utilized primarily by banks, rapidly became a market product available as a financial tool to diverse end-users. *Id.* at 46. Currently, "[t]he customized nature of derivatives allows end-users to hedge risk in a manner more closely resembling the actual risk that they are assuming than was ever possible with ordinary securities." Waldman, *supra* note 2, at 1029-30.

95. Waldman, *supra* note 2, at 1030. Multinational corporations such as McDonald's are one example of a prospective end-user class. *Id.* Because the assets of multinational corporations are located in multiple countries, the value of the corporation's assets and thus, the corporation as a whole, is especially vulnerable to fluctuations in non-U.S. currency. *See* GROUP OF THIRTY, *supra* note 17, at 37 (discussing Intel Corporation's successful use of hedging transactions to hedge approximately 90% of European order backlog against currency fluctuations).

96. *GORIS, supra* note 4, at 79.

97. *Id.*

98. *Id.*; *see* Hu, *supra* note 6, at 1466 (noting that end-users may prefer world where they have been able to eliminate market risks).

99. William Glasgall & Greg Burns, *Hedging Commandments: Rules to Live by in a Dangerous Game*, *BUS. WK.*, Oct. 31, 1994, at 98.

100. *Id.* Many corporations have been able to hedge successfully. *Id.* Among the most successful companies are Coca-Cola, Colgate-Palmolive, FMC, Ford, Lexmark, McDonald's, Merck, Mobil, 3M, and Union Carbide. *Id.* at 99.

101. *See* GROUP OF THIRTY *supra* note 17, at 36 (describing Ocean Spray's strategy of using derivatives as insurance to hedge against large, unfavorable interest rate changes that would negatively affect its short-term cash borrowings).

would not have to worry about interest rate fluctuations affecting its short-term borrowings.¹⁰² In order to ensure a stable rate, the end-user might take advantage of derivative instruments known as caps,¹⁰³ floors,¹⁰⁴ or collars.¹⁰⁵ By purchasing combinations of these instruments, the buyer contracts with a second party to pay a premium in advance¹⁰⁶ in exchange for reimbursement by the second party of any later incurred interest rate costs.¹⁰⁷ Thus, by using derivatives, the end-user effectively protects against rising or falling interest rates while taking advantage of any benefits conferred by the short-term floating rate.¹⁰⁸

4. Using Derivatives to Speculate for Profit

In contrast to risk reducing uses for derivatives, some derivative users employ derivatives in a speculative quest for profits.¹⁰⁹ The fundamental difference between risk reducing transactions and speculative uses is that the former reduce market risk while the latter increases it.¹¹⁰ Speculative uses aim to achieve profits

102. *Id.*

103. Andrew B. Giles, *Towards Diversification in THE REGULATIONS GOVERNING DERIVATIVES: AN INTERNATIONAL GUIDE*, INT'L 1992 FIN. L. REV. 4 (1992). A cap is "a contract between two parties under which the seller, in return for an up front premium, agrees to refund to the purchaser any excess interest costs over an agreed reference rate." *Id.* Caps provide a ceiling on the interest rate level affecting floating rate borrowings. *Id.* at 4-5.

104. *Id.* at 5. A floor is the opposite of a cap. *Id.* The seller of a floor receives a premium in return for which he agrees to compensate the buyer for the difference between actual interest rates and an agreed reference rate. *Id.* Floors protect the buyer against a fall in interest rates below a specified rate. *Id.*

105. *Id.* A collar is the purchase of a cap simultaneous to the sale of a floor. *Id.* Collars enable buyers to lock their interest costs into a specified range. *Id.*

106. *Id.* at 4. Alternatively the buyer may simply exchange any savings that he would receive resulting from downward moving interest rate for the reimbursement of future costs occurring as a result of upward moving rates. *Id.* This transaction would be a collar. *Id.*; see *supra* note 105 (defining collar).

107. Giles, *supra* note 103, at 4; see *supra* notes 103-04 (discussing caps and floors).

108. See GROUP OF THIRTY *supra* note 17, at 36 (noting Ocean Spray and Muzak's success using similar interest rate hedging techniques).

109. GORIS, *supra* note 4, at 82. Paul Goris defines speculation as "the conscious and deliberate exposure to market uncertainties with the intention of acquiring an economic benefit." *Id.*; see Glasgall & Burns, *supra* note 99, at 99 (noting that it is important for a financial manager to know whether his objective is to trade for profit or to offset changes in market values).

110. GORIS, *supra* note 4, at 77. The line between hedging and speculation is not always so clear. *Id.* Some derivatives such as swaps are often used primarily to speculate, and secondarily to hedge. *Id.* Alternatively, a transaction may initially exhibit speculative characteristics but then become a hedge or vice-versa. *Id.* at 82.

by maintaining open-market risk positions.¹¹¹ The ultimate profit or loss result of each position depends upon which direction the market moves.¹¹² The participant bets that the market will move favorable to his position.¹¹³

The popular currency swap where the initiating party does not possess an underlying position in the denominated currencies commonly exemplifies speculative derivatives use.¹¹⁴ In this arrangement, the initiating party agrees with a counterparty to swap certain fixed amounts of one currency for another over a period of time.¹¹⁵ The party is not interested in the nature of the currency flows but rather the difference between them.¹¹⁶ Speculation occurs because the initiating party bets that currency markets will move in such a way that it will be able to recognize a profit.¹¹⁷ If the market moves the other way, the initiating party will be responsible for the corresponding loss.¹¹⁸

D. *The Risks Accompanying Derivatives*

The financial benefits that end-users and dealers¹¹⁹ may recognize by participating in derivatives markets do not occur without corresponding financial risk.¹²⁰ Analysts broadly classify the risks end-users and dealers face by separating derivatives risks into several categories:¹²¹ mar-

111. *Id.* at 80.

112. *Id.*

113. *Id.* at 80-81. In discussing derivatives known as swaps, one may distinguish purely "speculative" use from "trading" use. *Id.* Trading use refers to the process of seeking profit from mediation fees earned in exchange for performing the swap for a third party. Trading use may also designate the specialized banking practice of exploiting temporary market imperfections for profit, known as arbitrage. *Id.* at 81.

114. *Id.* at 77.

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. See *supra* notes 36-56 and accompanying text (discussing derivatives users).

120. *Id.* at 43; see Hu, *supra* note 6, at 1467-71 (discussing financial risks accompanying derivatives, focusing specifically on credit and market risk); Waldman, *supra* note 2, at 1038-50 (discussing six commonly classified financial risks involved with derivatives).

121. Waldman, *supra* note 2, at 1038-39. These risks are roughly the same risks that banks and securities firms face during the course of their regular line of business. GROUP OF THIRTY, *supra* note 17, at 43. Thus, the risks are not new. *Id.* These risks do, however, present complex issues regarding how to minimize risk not normally found in the regular course of banking and securities business. *Id.*

ket,¹²² credit,¹²³ operational,¹²⁴ legal,¹²⁵ liquidity,¹²⁶ and systemic risk.¹²⁷ Together, the six risks compose the possibility that a derivatives transaction may not result as the participants had intended.¹²⁸

1. Market Risk

Like any other financial instrument, market risk resulting from the use of derivatives is the risk that the derivative instrument will not be as profitable as the investor had anticipated, due to market fluctuations.¹²⁹ Although the concept of market risk may be simple to understand, managing market risk has not been easy.¹³⁰ Commentators have suggested that market risks have been at the cause of the largest derivatives-related losses.¹³¹

Successful managers of market risk have been able to identify the market risks their investments face.¹³² Those investors that maintain a portfolio of derivative investments such as dealers, now typically manage the market risks of their derivatives on the basis of net exposure of the entire portfolio.¹³³ Determining the net exposure of the entire portfolio may prove difficult, as

122. *GROUP OF THIRTY*, *supra* note 17, at 43. Market risk is the risk that the financial instrument will lose its value to the investor. *Id.*

123. *Id.* at 47. Credit risk is generally the risk that a loss will incur if a counterparty defaults on the derivatives contract. *Id.*

124. *Id.* at 50. Operational risks refer to the risk of losses that may occur as a result of inadequate systems and control, human error, or management failure. *Id.*

125. *Id.* at 51. Legal risks are the risks of loss that may occur because a contract cannot be enforced. *Id.*

126. Waldman, *supra* note 2, at 1043-44. Liquidity risk is closely related to market risk in that it occurs where an asset cannot be sold quickly at a reasonable price. *Id.*

127. Hu, *supra* note 6, at 1054-55. Systematic risk refers to the risk that one party's inability to meet the obligations of its contract will create a domino effect of breached obligations among counterparties. *Id.* Of the four risks, commentators sometimes deem "credit" risk and "market" risk to be the most prominent. *Id.* at 1468.

128. Waldman, *supra* note 2, at 1038-39.

129. *See supra* note 122 (defining market risk); *see also* Hu, *supra* note 6, at 1469 (describing market risk as risk that value of underlying asset will move in wrong direction and noting that losses are potentially unlimited).

130. Waldman, *supra* note 2, at 1039-40.

131. *Id.* Bankers Trust lost US\$300 million to investments in derivatives following a 1994 rise in interest rates. *Id.* at 1040. A British multinational corporation, Allied-Lyons, lost UK£147 million betting against the U.S. dollar in 1991. *Id.*

132. *See GROUP OF THIRTY*, *supra* note 17, at 43-44 (discussing managerial approaches to identifying market risks).

133. *Id.* at 43. An entire portfolio will often contain many offsetting positions and thus, the overall risk of the portfolio may be substantially less than the individual investments. *Id.*

the user must first identify the fundamental risks and exposures of each individual investment in the portfolio.¹³⁴

Upon identifying the risks that may devalue their investments, managers can avoid devaluation by employing hedging strategies.¹³⁵ By investing in financial instruments whose value will move inversely in equal amounts to movements in the entire portfolio, the manager ensures that the market risk of the portfolio is kept to a minimum.¹³⁶ Even though a money manager may protect his portfolio against most market risk, the manager may still find it difficult to protect against all market risk.¹³⁷ High transaction costs may additionally prohibit otherwise efficient hedging opportunities.¹³⁸

2. Credit Risk

Whereas the volatility of underlying markets determines the amount of market risk involved in a derivatives transaction,¹³⁹ the credit worthiness of the two parties to the transaction determines the amount of credit risk involved.¹⁴⁰ Credit risk is the risk that one of the parties to the derivative transaction will default on its obligations arising from its entering into the transaction.¹⁴¹ When one party defaults, the other will not receive its benefit unless it enters into a replacement contract and thus, the cost of default to that party is the cost of replacing the contract with a new one.¹⁴²

134. *See id.* (discussing types of risks that may affect each individual investment).

135. *See supra* notes 93-108 and accompanying text (discussing hedging).

136. *See* GROUP OF THIRTY, *supra* note 17, at 36 (discussing Ocean Spray savings).

137. Hu, *supra* note 6, at 1468-70. Identifying the risks a portfolio faces may prove very difficult as many different factors influence a portfolio's value. *Id.* at 1468. Determining the value of an option-based portfolio, for example, requires identification of the probable distribution of prices for the underlying asset at maturity. *Id.*

138. *Id.* at 1469. One popular type of hedging strategy that can prove cost prohibitive is "delta hedging." Waldman, *supra* note 2, at 1044-45. A delta hedging manager continuously realigns the hedge's position with regard to the portfolio so as to maximize the hedge's effectiveness and opportunity for profit. *Id.* Delta hedging may, however, require high transaction costs, and may also not be efficient in non-liquid markets. *Id.*

139. *See supra* notes 129-37 and accompanying text (discussing market risk).

140. *See supra* note 123 (discussing credit risk).

141. GROUP OF THIRTY, *supra* note 17, at 47. Credit risk losses have so far been relatively small. GAO REPORT, *supra* note 2, at 52. For 1992, major OTC derivatives dealers reported credit losses as less than one-half of one percent of their gross credit exposures. *Id.* at 52.

142. GAO REPORT, *supra* note 2, at 52. Credit risk calculations are especially im-

In order to calculate the level of credit risk accompanying a derivative contract, a party must determine both the cost of replacing the contract if the counterparty were to default immediately and the replacement cost if the counterparty were to default at some time in the future.¹⁴³ The cost of replacing the contract today, or “current” replacement cost, is equal to the value of the expected future cash flows that the non-defaulting party would have received if not for the breach by the defaulting party.¹⁴⁴

The cost of replacing the contract in the future is the potential replacement cost.¹⁴⁵ Potential replacement cost accounts for changes in value the derivative contract would have incurred in response to underlying market movements.¹⁴⁶ Calculating potential replacement cost is more difficult and less precise than calculating current replacement cost.¹⁴⁷ In contrast to requiring a calculation of value occurring at a fixed point in time, as does current replacement cost, potential replacement cost constantly

portant to end-users engaging in over-the-counter derivatives transactions. *GROUP OF THIRTY*, *supra* note 17, at 48. Unlike exchange-traded derivatives, OTC derivatives do not pass through a dealer and thus the parties rely on one another for performance of the contract. Waldman, *supra* note 2, at 1047. Thus, calculating the likelihood of counterparty default is central to the value of the contract. *Id.* at 1049.

143. *See* *GROUP OF THIRTY*, *supra* note 17, at 47 (noting that two determinations may be considered “current” and “potential” exposures). Credit risk is not necessarily a factor for both parties, as some transactions create one-sided credit exposure. *Id.* at 48. For example, the buyer of an option often pays the full price of the option at the time of initiating the option contract. *Id.* The seller, however, is not under an obligation to perform until such time as the buyer decides to exercise the option. *Id.* Thus the buyer is exposed to the credit risk that the seller will not perform when the buyer exercises the option. *Id.* The buyer thus incurs credit risk, whereas the seller does not. *Id.*

144. *Id.* at 47. Counterparty default does not always cause a loss. *Id.* Some transactions, such as swaps and forwards, require that in order for there to be a loss, the counterparty must not only default but the replacement cost must also be positive, so that no profit is gained as a result of the loss. *Id.*

145. *Id.*

146. Waldman, *supra* note 2, at 1048. For example, a true measure of credit risk would be able to account for the risk of having to replace a derivatives contract where market volatility had driven the value of that contract up or down. *See id.* (describing devaluation of options as time to expiration date diminishes).

147. Hu, *supra* note 6, at 1468-69. A completely accurate measure of credit risk would require being able to predict the future because otherwise it is impossible to determine the distribution of market prices that will affect the value of the derivative contract. *Id.*; *see* *GROUP OF THIRTY*, *supra* note 17, at 47 (noting that credit risk calculations are at best mere estimates); Waldman, *supra* note 2, at 1048 (noting that even with complex computer modeling techniques, calculation of credit risk is imprecise science).

changes as market volatility affects relevant variables.¹⁴⁸ An accurate estimate of total credit risk may thus, not be possible at all times as any assessment of credit risk may be more characteristic of a best estimate than a precise measure.¹⁴⁹ Calculating the credit risk of an entire portfolio as compared to a single derivative investment, is even more complex and less likely to be accurate.¹⁵⁰

3. Operational Risk

Operational risk broadly refers to the risk that losses will occur as a result of improper or undesired functioning of trading and management systems.¹⁵¹ Two common operational risks are the risks of human error and management or technological lapses.¹⁵² To reduce operational risk, derivatives users have instituted several main types of internal controls.¹⁵³

Some examples of operational risk-reducing strategies include: documentation of policies and procedures regarding approval requirements, dollar limits, and activity disclosure.¹⁵⁴ These strategies are designed to set forth clear rules as to what

148. Waldman, *supra* note 2, at 1468-69.

149. GROUP OF THIRTY, *supra* note 17, at 47.

150. *Id.* at 47. Calculations of current portfolio replacement cost must take into account the application and enforceability of bilateral netting agreements. *Id.* at 48. Netting agreements allow parties to combine offsetting payment obligations arising from multiple transactions into one total payment, thus leaving only one obligation to be fulfilled. GAO REPORT, *supra* note 2, at 65. When netting applies, the credit exposure of a portfolio is the sum of positive and negative values of each contract. GROUP OF THIRTY, *supra* note 17, at 48.

Determining whether netting applies raises certain legal issues. GAO REPORT, *supra* note 2, at 65. Uncertainty remains as to whether some netting agreements, specifically agreements that net across product types, will be enforceable under U.S. law. *Id.* The Group of Thirty report recognizes however, that widely used standard documentation and changes in the legal environment in several jurisdictions have answered specific enforceability issues and eased legal concerns. GROUP OF THIRTY, *supra* note 17, at 51. The Group of Thirty report also recognized enforceability issues with regard to netting in other countries and called for increased clarity across transnational borders. See generally GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES PRACTICES AND PRINCIPLES 1 (Group of Thirty eds. 1993) (App. II: Legal Enforceability; Survey of Nine Jurisdictions) (1994) (discussing enforceability issues in two jurisdictions, Australia and Japan, where the enforceability of netting agreements are particularly questionable, and gambling statutes in Brazil, Canada, and Singapore that also make treatment of derivatives uncertain in these jurisdictions).

151. GROUP OF THIRTY, *supra* note 17, at 50.

152. *Id.*

153. *Id.*

154. *Id.*

personnel may and may not do in the exercise of their duties.¹⁵⁵ Independent audits and risk management review, provide checks and balances from neutral sources outside the firms utilizing derivatives.¹⁵⁶ Additionally, new technology and accounting systems have lowered operational risks by increasing efficiency in confirmation and payment systems.¹⁵⁷

4. Legal Risk

Legal risk is the risk of loss due to the unenforceability of a derivatives contract.¹⁵⁸ Parties to a derivatives contract first calculate legal risk when there is doubt as to whether the terms of the derivatives contract may violate a law.¹⁵⁹ Legal risk also accounts for the possibility that a party involved in the contract may not have the legal authority to enter into such obligations.¹⁶⁰ Uncertainty resulting from the question of whether courts will enforce specific contractual provisions has additionally been subject to focus in calculating legal risks.¹⁶¹

5. Liquidity Risk

Liquidity risk is generally the risk that an asset may not be sold promptly for a reasonable price.¹⁶² This kind of risk is closely associated with market risk¹⁶³ because it refers to the possibility that a particular transaction in a certain instrument may

155. *Id.*

156. *Id.*

157. *Id.*

158. GAO REPORT, *supra* note 2, at 64; see GROUP OF THIRTY, *supra* note 17, at 51 (defining legal risk as risk of loss incurred when contract may not be enforced).

159. See GAO REPORT, *supra* note 2, at 64 (discussing decreased possibility that derivative contract will violate Commodities Exchange Act ("CEA") now that Commodities Futures Trading Commission has exempted swaps from most CEA provisions).

160. See *Hazell v. Hammersmith & Fulham, L.B.C.*, 2 W.L.R. 372 (1991) (holding London Borough's interest rate swap agreements unenforceable due to borough's lack of authority to enter into such contracts); see also GROUP OF THIRTY, *supra* note 17, at 51 (discussing British case of Hammersmith & Fulham). In the United Kingdom, defenses to enforceability based on the grounds that one party lacked authority to enter into the derivatives contract have produced some of the largest derivatives losses to date. GAO REPORT, *supra* note 2, at 64.

161. *Id.*

162. Waldman, *supra* note 2, at 1043; see ROBERT A. SCHWARTZ, EQUITY MARKETS: STRUCTURE, TRADING, AND PERFORMANCE 523 (1988) (discussing definitions and empirical measures of liquidity).

163. See *supra* notes 129-38 and accompanying text (discussing market risk).

have a noticeable effect on the price of that instrument.¹⁶⁴ Liquidity risk also embodies concepts of credit risk¹⁶⁵ in that liquidity risk may increase when a particular party temporarily is not liquid and therefore, is unable to meet its obligations.¹⁶⁶

In order to combat liquidity risk, derivatives users have developed complex hedging strategies to offset prospective losses.¹⁶⁷ Delta hedging is one common technique whereby a portfolio manager continuously adjusts the hedge position of the portfolio as markets move up or down.¹⁶⁸ Thus, one benefit of this technique is the elimination of the risk that substantial loss will occur as a result of a counterparty's illiquidity.¹⁶⁹

Critics of delta hedging have pointed out its faults, however.¹⁷⁰ A primary fault of delta hedging and other hedging techniques is that they presuppose the existence of a liquid market.¹⁷¹ Although hedges may protect against illiquidity of one or a handful of counterparties, should widespread illiquidity strike financial markets, hedging techniques would become ineffective.¹⁷²

6. Systemic Risk

Systemic risk is the risk that one party's inability to meet its obligations could cause a domino effect amongst other parties,

164. GROUP OF THIRTY, *supra* note 17, at 46.

165. See *supra* notes 139-50 and accompanying text (discussing credit risk).

166. Waldman, *supra* note 2, at 1043-44. Market participants are unlikely to transact with a counterparty that is perceived to be non-liquid. *Id.*

167. *Id.* at 1044-47; see *supra* notes 93-108 (discussing hedging uses and techniques).

168. Waldman, *supra* note 2, at 1044; see *supra* note 138 (discussing delta hedging).

169. Waldman, *supra* note 2, at 1044. Delta hedging also facilitates profit-taking, unlike mirror hedges which are designed to yield no profit. *Id.*

170. See Hu, *supra* note 6, at 1479 (noting that sophisticated hedging techniques are imperfect when market conditions become chaotic).

171. See Waldman, *supra* note 2 (discussing presupposition of creators of hedging techniques that markets will remain liquid).

172. Hu, *supra* note 6, at 1479. Unstable market conditions such as those that occurred in the Fall 1992 European currency crisis may render impossible the adjustments upon which hedging techniques rely. *Id.* The "portfolio insurance" technique, as used prior to the 1987 stock market crash, illustrates just such a problem. Waldman, *supra* note 2, at 1045-46. Prior to the crash, portfolio managers engaged in portfolio insurance techniques by purchasing derivatives that were designed to increase in value in the event that equity assets in the portfolio were to decrease. *Id.* The insurance method failed, however, as buyers and sellers of the insuring instruments disappeared because of the rapid decrease in stock prices. *Id.*

causing the other parties to default on their obligations.¹⁷³ Systemic risk largely arises because most derivatives transactions are not fully secured.¹⁷⁴ Derivatives users and dealers often rely on payments coming in from one contract to pay another.¹⁷⁵ If those payments should cease, as would be the case were the payments to come from a non-liquid party, the user or dealer would not be able to meet payment obligations of its own.¹⁷⁶ Systemic risk, thus, accounts for the possibility that industry reliance on hedging strategies could worsen an illiquidity-driven market downturn, by factoring in the possibility that one party's illiquidity could cause widespread liquidity problems.¹⁷⁷

Commentators note that several factors may exacerbate the transmission of illiquidity.¹⁷⁸ First, a large portion of derivatives business is conducted amongst a relatively small group of participants.¹⁷⁹ Full market illiquidity may therefore arise from illiquidity of only a few big market participants.¹⁸⁰ Second, particular obligations are often interconnected among institutions.¹⁸¹ A large number of transactions may involve a much smaller number of counterparties and thus the failure of one counterparty is likely to have broad-reaching effects.¹⁸² Third,

173. BANK FOR INTERNATIONAL SETTLEMENTS, REPORT OF THE COMMITTEE ON INTERBANK NETTING SCHEMES OF THE GROUP OF TEN COUNTRIES 9 (1990). Systemic risk is the risk that "illiquidity or failure of one institution, and its resulting inability to meet its obligations when due, will lead to the illiquidity or failure of other institutions." *Id.*; see Waldman, *supra* note 2, at 1053-54. Systemic risk can be separated into two scenarios. *Id.* First, the situation where one party's inability to meet its contractual obligations causes a defaulting domino effect amongst financial institutions. *Id.* Second, the widespread reliance of investors on hedging strategies worsens an otherwise containable market downturn. *Id.*

174. William Glasgall & Bill Javetski, *Swap Fever: Big Money, Big Risks*, *Bus. Wk.*, June 1, 1992, at 102-03.

175. See Waldman, *supra* note 2, at 1055 (discussing concern that failure of one party to meet its obligations will cause other parties to do same).

176. *Id.*

177. *Id.* at 1054-56.

178. See, e.g., *id.* at 56 (noting that small quantity of large derivatives markets participants and interconnection of swap markets may worsen problem of systemic risk).

179. Glasgall & Javetski, *supra* note 174 (noting that many traders conduct business with only small group of highly-rated banks).

180. See Waldman, *supra* note 2 at 1054-56 (discussing likelihood that failure of one institution could cause similar failures throughout industry).

181. See Keith Schap, *When Domino Theory Meets OTC Credit Risk*, *FUTURES*, Aug. 1992, at 38, 40 (discussing Merrill Lynch subsidiary's 161 transactions that only involved 51 counterparties); Glasgall & Javetski, *supra* note 174, at 102, 104 (discussing single finance deal that required 240 swap transactions in order to balance).

182. Waldman, *supra* note 2, at 1054-56.

the long-term nature of some derivatives contracts¹⁸³ increases systemic risk by providing a greater opportunity for counterparty default.¹⁸⁴

E. *An Overview of the Regulatory Framework Governing Derivatives*

Regulations governing derivatives are the result of a mixed basket of requirements aimed not specifically at derivatives, but rather, the financial industry in general.¹⁸⁵ Securities and commodities laws, together with requirements issued by the Federal Reserve Board¹⁸⁶ and the Office of the Comptroller of the Currency,¹⁸⁷ broadly affect derivatives markets by imposing upon derivatives traders, mandatory rules and guidelines.¹⁸⁸ Private groups like the Financial Accounting Standards Board¹⁸⁹ and the International Swaps and Derivatives Association¹⁹⁰ have also contributed rules and requirements to the regulatory framework governing derivatives markets.¹⁹¹

183. See GROUP OF THIRTY, *supra* note 17, at 54 (discussing difference in risk levels of one-year contract compared to ten-year contract).

184. Claire Makin, *Hedging Your Derivatives Doubts*, INSTITUTIONAL INVESTOR, Dec. 1991, at 113, 119. Parties are more likely to default on a contract if they are provided more opportunities to do so. *Id.*; see Lisa Vaughan, *Swaps Boom Worries Regulators*, INDEPENDENT, Aug. 25, 1992, at 19 (discussing fears of deputy head of banking supervision at Bank of England that longer duration contracts increase exposure to counterparty default).

185. See Charles E. Dropkin et al., *United States in The Regulations Governing Derivatives: An International Guide*, 1992 INT'L FIN. L. REV. 38 (noting that different types of derivatives are subject to different regulatory requirements depending on derivative's particular characteristics).

186. See *id.* at 51 (noting that Federal Reserve Board is principal regulator of bank holding companies and state-member banks).

187. See *id.* at 52 (noting that Office of Comptroller of Currency is chief regulator of U.S. national banks).

188. See *id.* at 51-53 (discussing power of Federal Reserve Board and Office of Comptroller of Currency to regulate derivatives).

189. See ROBERT F. MEIGS & WALTER B. MEIGS, FINANCIAL ACCOUNTING 12 (6th ed. 1989) (discussing history and role of Financial Accounting Standards Board). A private agency, the FASB has been instrumental in developing and recognizing generally accepted accounting principles. *Id.* Composed of seven full-time members, the FASB conducts extensive research of accounting issues and releases statements of accounting standards that represent authoritative expressions of generally accepted accounting principles. *Id.*

190. See Cunningham, *supra* note 19, at 138 (discussing role of International Swaps and Derivatives Association in regulating derivatives). The ISDA is a private industry trade association that has been instrumental in the development of standard documentation in the derivatives industry. *Id.*

191. *Id.*

1. Securities Regulation

Forming the backbone of U.S. securities law are the Securities Act of 1933¹⁹² ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").¹⁹³ Whereas the Securities Act essentially governs the initial infusion of securities into securities markets,¹⁹⁴ the Exchange Act addresses regulation of those securities once they are in circulation.¹⁹⁵ Both the Securities and the Exchange Acts govern only those instruments that the acts define as securities.¹⁹⁶ The defined instruments include, for example, notes, stocks, bonds, puts, calls, options, privileges that are traded on national securities exchanges, or any instrument commonly known as a security.¹⁹⁷ The Exchange Act also created the Securities Exchange Commission,¹⁹⁸ an independent, non-partisan regulatory agency whose purpose it is to administer

192. 15 U.S.C. §§ 77a-77z (1988 & Supp. V 1993).

193. 15 U.S.C. § 78 (1934 & Supp. 1993). Five statutes in addition to the two securities acts, and the rules and regulations promulgated under all seven, comprise the federal securities laws. JENNINGS, *supra* note 29, at 99. The additional statutes are: the Public Utility Holding Act of 1935, 15 U.S.C. § 79 (1935 & Supp. V 1993), the Trust Indenture Act of 1939, 15 U.S.C. § 77 (1939 & Supp. V 1993), the Investment Company Act of 1940, 15 U.S.C. § 80 (1940 & Supp. V 1993), the Investment Advisers Act of 1940, 15 U.S.C. § 80 (1940 & Supp. V 1993), and the Securities Investor Protection Act of 1970, 15 U.S.C. § 78 (1988). THOMAS LEE HAZEN, *FEDERAL SECURITIES LAW: FEDERAL JUDICIAL CENTER 1* (1993).

194. JENNINGS, *supra* note 29, at 99.

195. *Id.*

196. *Id.*

197. 15 U.S.C. § 77(b). The Exchange Act defines security as [a]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to non-U.S. currency, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id. The Securities Act definition of security is almost identical to the Exchange Act definition. 15 U.S.C. § 78(c). The Exchange Act definition, however, does not apply to any note, draft, bill of exchange, or banker's acceptance that has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. *Id.*

198. 15 U.S.C. § 78d. The Securities Exchange Commission is responsible for en-

and enforce the federal securities laws.¹⁹⁹

Derivative financial instruments do not fit neatly within definitions of securities and, thus, the purview of federal securities laws.²⁰⁰ The acts' definitions of security, although covering those financial instruments that are traded on national securities exchanges, have not been interpreted to include many types of derivative products.²⁰¹ By falling outside the definition of security, non-exchange traded derivatives avoid three substantial aspects of the federal regulatory system.²⁰² First, non-security derivatives are not subject to the mandatory disclosure system that applies to the sale and trading of security instruments.²⁰³ Second, unlike non-security derivatives, securities face stiff anti-fraud provisions not found in common law.²⁰⁴ Finally, financial intermediaries that deal in the securities that fall within the definitions under the acts, face close substantive regulation by the

ensuring fairness and honesty in the securities markets as well as adequate disclosure to investors. JENNINGS, *supra* note 29, at 99.

199. JENNINGS, *supra* note 29, at 98.

200. See Horwitz, *supra* note 69, at 526 (discussing question of what constitutes security under Securities and Exchange Acts).

201. Cunningham, *supra* note 19, at 162. The nontransferable character and two party nature of OTC derivatives is largely responsible for the broad view that OTC derivatives are not securities. *Id.* Swaps are not securities under federal securities laws and therefore, registration provisions of the Securities Act and anti-fraud provisions of the Exchange Act are inapplicable. Dropkin, *supra* note 185, at 38. In addition, swap participants are not required to register as broker-dealers under the Exchange Act, and neither are investment companies under the Investment Company Act of 1940, merely because there is swap activity in their portfolios. *Id.*; see Horwitz, *supra* note 69, at 525 (discussing court decisions interpreting definitions of security under Securities and Exchange Acts).

202. JENNINGS, *supra* note 29, at 2.

203. *Id.* at 29. The Securities and Exchange Acts combine to create what is known as an integrated disclosure system. HAROLD S. BLOOMENTHAL & HOLME ROBERTS & OWEN, *SECURITIES LAW HANDBOOK* 59 (1994). This integrated system requires disclosure in connection with public offerings of securities as well as disclosure on a continuous basis for companies with securities registered under the Acts. *Id.* For a general discussion of the disclosure system and its requirements, see *id.* at 59-134 (providing overview of integrated disclosure system). See also THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* 56-232, 388-98 (2d ed. 1990) (discussing registration and reporting requirements under Securities and Exchange Acts).

204. JENNINGS, *supra* note 29, at 2. For a general discussion of the anti-fraud provisions under the federal securities laws and other remedies for securities law violations, see HAZEN, *supra* note 203, at 52-220. See, e.g., Rule 10b-5, 17 C.F.R. § 240 (1994) (prohibiting employment of manipulative and deceptive devices in connection with purchase or sale of security).

Securities Exchange Commission.²⁰⁵ Dealers of derivatives that do not fall within the definition of security, under the Securities and Exchange Acts, are not subject to similar regulation.²⁰⁶

As regulators have threatened to treat certain types of derivatives as securities and thus subject them to the regulatory framework of the Securities and the Exchange Acts, financial innovators have responded by creating new financial instruments that do not fall within established definitions of a security.²⁰⁷ For example, swap participants may minimize potential exposure to federal securities laws by structuring their transaction in such a way as to fall outside the jurisdiction of securities laws.²⁰⁸

2. Commodities Regulation

Supplementing securities laws in the governance of derivatives are federal commodities laws.²⁰⁹ The current commodity

205. See JENNINGS, *supra* note 29, at 625-51 (discussing regulation of trading activities by brokers and dealers of securities).

206. *Id.* at 2. Derivative dealers are not required to register under either the Securities or Exchange Acts, unlike dealers in securities. Cunningham, *supra* note 19, at 162. Dealers that are registered under the Acts that choose to deal in derivatives are also subject to the SEC's net capital rules as contained in Rule 15c3-1 under the Exchange Act. 17 C.F.R. § 240 (1994). For a discussion of net capital rules and related requirements, see BLOOMENTAL, *supra* note 203, at 1042. The Final Temporary Risk Assessment Rules adopted by the SEC on July 16, 1992 impose additional requirements upon those dealers that are required to register under the Acts. 17 C.F.R. § 240.17(h) (1994). These rules require broker-dealers to maintain records and file with the SEC on a quarterly and annual basis certain information regarding for example, risk management policies and aggregate amounts of interest rate swaps and other instruments with similar risk characteristics. *Id.*; see Cunningham, *supra* note 19, at 163 (describing requirements of Final Temporary Risk Assessment Rules).

207. See Dropkin, *supra* note 185, at 38 (discussing ability of swap market participants to structure their transactions so they fit within exemptions of Securities Act).

208. *Id.*

209. Dropkin, *supra* note 185, at 39. The Commodity Exchange Act, 7 U.S.C. § 1 (1988 & Supp. V 1993) [hereinafter CEA] at § 2 provides that the Commodities Futures Trading Commission shall:

[h]ave exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act. Except as hereinabove provided, nothing contained in this section shall (I) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (II) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws.

regulatory framework has developed from the provisions of the Commodity Exchange Act ("CEA")²¹⁰ and the Commodity Futures Trading Commission Act ("CFTC Act").²¹¹ Congress passed the CEA in 1936 to expand the Department of Agriculture's authority over commodities markets.²¹² In 1974, Congress passed the CFTC Act to stabilize volatile commodities markets and to create a federal regulatory agency to oversee commodities market activities.²¹³ The CEA, as amended,²¹⁴ provides that transactions in commodity future and commodity option contracts must occur be subject to the supervision of the Commodity Futures Trading Commission ("CFTC").²¹⁵

The CEA defines commodity as including a variety of agricultural products from corn, butter, and eggs to grain sorghums, flaxseed, livestock, and all other goods and articles.²¹⁶ The definition also includes however, all services, rights, rights and interests in which contracts for future delivery are presently or in the future dealt in.²¹⁷ Under this definition, some derivatives such as futures and options contracts could be subject to the jurisdiction of the CFTC.²¹⁸ Rather than interpreting the definition as a blanket inclusion of futures and options however, the CFTC has instead limited its authority to the power of governing those

Id. § 2(a)(1)(A)(i).

210. 7 U.S.C. § 1.

211. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (codified at 7 U.S.C. § 4(a) (1988 & Supp. V 1993)).

212. Frank S. Shyn, *Internationalization of the Commodities Market: Convergence of Regulatory Activity*, 9 AM. U. J. INT'L L. & POL'Y 597, 606-07 (1994).

213. *Id.*

214. See Mahlon M. Frandhauser & Ellen S. Levinson, *Commodity Exchange Act Amendments*, 25 REV. SEC. & COMM. REG. 245 (1992) (discussing amendments to commodities acts).

215. CEA § 4; see Cunningham, *supra* note 19, at 164-67 (discussing provisions and requirements of commodities acts).

216. 7 U.S.C. § 1a(3). The Commodity Exchange Act defines commodity as: wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in Public Law 85-839 (7 U.S.C. § 13-1), and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.

Id.

217. *Id.*

218. Cunningham, *supra* note 19, at 164.

transactions occurring on exchanges.²¹⁹

The inclusion in the CEA of the Treasury Amendment,²²⁰ places certain derivative instruments outside the reach of CFTC regulation.²²¹ Most notably the Treasury Amendment exempts derivative transactions in non-U.S. currencies.²²² Consequently, swaps, one of the most popular families of derivatives,²²³ do not fall within the CFTC's regulatory scope.²²⁴

Certain other commodity contracts are exempt from CFTC jurisdiction under the trade option exemption.²²⁵ This exemption authorizes particular commodity option transactions that are not executed on designated contract markets and are offered to commercial users in the line of their business.²²⁶ The offeror need only reasonably believe that the prospective offeree will use the option in the method the rule requires.²²⁷

219. See Dropkin, *supra* note 185, at 39 (noting that general requirement of exchange trading contrasts broader regulatory approach of SEC). This narrow approach is consistent with the plain language of the Commodity Exchange Act, which limits the CFTC's authority to transactions conducted on exchanges. See 7 U.S.C. § 2(a)(1)(A)(i) (limiting CFTC's jurisdiction to contracts executed on markets designated by Section 5 of Act, or any other board of trade, exchange or market).

220. 7 U.S.C. § 2 (1988 & Supp. V 1993).

221. *Id.* § 2(a)(1)(A)(ii). The Treasury Amendment provides:

[n]othing in this Act shall be deemed to govern or in any way be applicable to transactions in non-U.S. currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitment, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

Id.; see 50 Fed. Reg. 42,963 (1985) (CFTC's statutory interpretation).

222. 7 U.S.C. § 2(a)(1)(A)(ii). Many of the other instruments exempted by the Treasury Amendment fall under the regulatory regimes of other agencies. See, e.g., 15 U.S.C. § 78 (1988 & Supp. V 1993) (defining security warrants within definition of security).

223. See Dropkin, *supra* note 185, at 36 (estimating size of swap market to be US\$3 trillion). The Fourth Circuit has concluded that the Treasury Amendment exempts all off-exchange transactions in non-U.S. currency, including futures and options. *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966, 976 (1993), *cert. denied*, 114 S. Ct. 1540 (1994).

224. See Camden R. Webb, Note, *Salomon Forex, Inc. v. Tauber — The "Sophisticated Trader" and Foreign Currency Derivatives Under the Commodity Exchange Act*, 19 N.C. J. INT'L L. & COM. REG. 579 (1994) (describing non-U.S. currency swaps exclusion from CFTC jurisdiction).

225. 17 C.F.R. § 32.4(a) (1994).

226. 17 C.F.R. § 32.4(a). The rule states that the offeree must either be first, a commercial user of, or a merchant handling the commodity, and second, the offering must be solely related to the offeror's business. *Id.*

227. *Id.*; see Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 n.14 (1989) (noting that only offeree of trade option need satisfy commercial user or merchant requirement).

In further limiting its regulatory control of derivatives, the CFTC recently exempted²²⁸ swap agreements²²⁹ from its jurisdiction, provided the agreements and swap participants meet certain requirements.²³⁰ In granting the CFTC authority to exempt these types of interests,²³¹ Congress did not intend to determine the legality of securities-based swaps or other transactions, taking place in the off-exchange private marketplace, that otherwise

228. Cunningham, *supra* note 19, at 164. The CFTC adopted the exemptive regulations on January 14, 1993 in response to authority Congress granted to it in the Future Trading Practices Act of 1992 ("FTPA") Pub. L. No. 102-546, 106 Stat. 3590 (1992) (codified at 7 U.S.C. 1). *Id.* Congress passed the FTPA with strong expectations that the CFTC would utilize its new exemptive powers in four particular areas. *Id.* The four types of instruments, hybrids, swaps, forwards, and bank deposits/accounts, are instruments that have caused significant concern regarding legal enforceability. *Id.* To date, the CFTC has only exempted swap agreements. 17 C.F.R. §§ 35.1-35.2 (1993).

229. 17 C.F.R. § 35.1(b). The exemption defines "swap agreement" as:

- (i) An agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward non-U.S. exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);
- (ii) Any combination of the foregoing; or
- (iii) A master agreement for any of the foregoing together with all supplements thereto.

Id. The CFTC in granting the exemption did not, however, exempt parties from financial, record-keeping, reporting, or other requirements flowing from current CEA regulation. Cunningham, *supra* note 19, at 165.

230. 17 C.F.R. § 35.2. To satisfy the swap exemption the transaction must satisfy the following requirements:

- (a) The swap agreement is entered into solely between eligible swap participants at the time such persons enter into the swap agreement;
- (b) The swap agreement is not part of a fungible class of agreements that are standardized as to their material economic terms;
- (c) The creditworthiness of any party having an actual or potential obligation under the swap agreement would be a material consideration in entering into or determining the terms of the swap agreement, including pricing, cost, or credit enhancement terms of the swap agreement; and
- (d) The swap agreement is not entered into and traded on or through a multilateral transaction execution facility.

Id. The exemption states, however, that paragraphs (b) and (d) are not to be applied to preclude netting arrangements between parties to swap agreements. *Id.* Finally, the exemption allows for any person to apply directly to the CFTC for an exemption from provisions of the Commodities Exchange Act and other regulatory regimes. *Id.*

231. *See supra* note 228 (discussing congressional expectations with regard to granting CFTC authority to exempt certain types of financial instruments).

comply with applicable regulations.²³² Prior to the 1993 swap exemption, the CFTC approved a policy statement in 1989 that set forth a nonexclusive safe harbor from CFTC regulation for certain types of swap transactions.²³³ In adopting the new exemption, the CFTC intended it to coexist with the existing safe harbor rather than replace it.²³⁴

3. Bank Capital Adequacy Guidelines

Both the Office of the Comptroller of the Currency²³⁵ ("OCC") and the Federal Reserve Board²³⁶ ("FRB") also have substantial power to affect the use of derivatives.²³⁷ Whereas the SEC and CFTC arguably have direct statutory jurisdiction over many derivative instruments,²³⁸ the OCC and the FRB affect derivatives through governance of banks in the United States.²³⁹ Because banks are a principal user of derivative products,²⁴⁰ re-

232. Cunningham, *supra* note 19, at 166 (discussing congressional intentions involved in passage of Future Trading Practices Act).

233. Commodity Futures Trading Commission, Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (1989) (hereinafter Policy Statement). In order to qualify for the safe harbor provision, the transaction must meet the following requirements. *Id.* First, the transaction may only be consummated after individual credit determinations and private negotiation with regard to material terms. *Id.* at 30,696. Second, the transaction must create obligations that, absent default, may only terminate upon consent of the counterparty. *Id.* Third, the transaction may not rely on third party clearing organizations or margin systems. *Id.* In other words, the transaction may not rely on margin or settlement systems designed to reduce or eliminate individualized credit risk. *Id.*; see Cunningham, *supra* note 19, at 166 (noting safe harbor only applies to transactions that are not subject to clearing organizations or margin systems). Fourth, as the safe harbor is intended to preclude availability to public participation, the transaction must be undertaken in conjunction with the participants' line of business. Policy Statement at 30,696-97. Finally, consistent with the previous requirement, participants may not market the transaction to the general public. *Id.*

234. See Cunningham, *supra* note 19, at 166 (noting that CFTC did not intend to replace safe harbor with new exemption and furthermore, that market participants may continue to rely on safe harbor in forming new swap agreements).

235. See *supra* note 187 and accompanying text (discussing role of OCC in regulating U.S. banks and derivatives trading).

236. See *supra* note 186 and accompanying text (discussing regulatory role of Federal Reserve Board).

237. Dropkin, *supra* note 185, at 52.

238. See *supra* notes 192-234 and accompanying text (discussing jurisdiction of SEC and CFTC with regard to derivatives).

239. *Id.* at 51-53.

240. *Id.* at 51. Although there are approximately six-hundred banks that use derivatives, roughly ten institutions control ninety percent of the market. See Barbara A. Rehm, *Regulators Try to Reassure Lawmakers on Swaps*, AM. BANKER, Oct. 29, 1993, at 3 (discussing composition of derivatives users).

quirements the OCC and FRB impose upon the banking industry have the potential to widely affect derivative instruments.²⁴¹ Both organizations have issued guidelines that directly affect the use of derivatives. The Federal Deposit Insurance Corporation²⁴² ("FDIC") has also followed suit, thus rounding out the imposition of capital guidelines upon financial institutions.²⁴³

The Bank Capital Adequacy Guidelines issued by the FRB in 1989²⁴⁴ and similar guidelines adopted by the OCC²⁴⁵ and FDIC²⁴⁶ in 1990 govern levels of risk banks may carry in relation to amounts of capital.²⁴⁷ The guidelines assign risk weightings to different types of bank assets and compare the total of risk-adjusted assets to qualified quantities of capital.²⁴⁸ The guidelines prohibit risk levels above minimum capital to asset ratios.²⁴⁹ If

241. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: ITS PURPOSES AND FUNCTIONS 109 (1939) [FEDERAL RESERVE SYSTEM]. One of the specific duties of the FRB is to give particular attention to speculation involved in the banking industry. *Id.* The FRB has authority to take action to prevent undue speculation in the banking industry, specifically in the use of risky commodities and securities. *Id.* Such authority is consistent with the FRB's purpose of exerting a stabilizing and corrective influence upon the U.S. banking system. *Id.* at 110.

242. Ernest T. Patrikis et al., *Managing Risk Exposure in Derivatives: How to Deal With Recent Regulatory and Legislative Developments*, in MANAGING RISK EXPOSURE IN DERIVATIVES 150 (PLI Corporate Law and Practice Course Handbook Series No. B4-7089 (1994)). The FDIC has some authority over all institutions with Federal Deposit Insurance, including, national, state and non-U.S. banks, as well as savings institutions. *Id.* Most banks are insured by the FDIC, and thus fall within FDIC regulation. JENNINGS, *supra* note 29, at 78. The FDIC serves, in part, to ensure that financial institutions maintain appropriate capital levels, expertise, and management controls in the course of operations. FEDERAL RESERVE SYSTEM, *supra* note 241, at 150-51.

243. FEDERAL DEPOSIT INSURANCE CORPORATION, FDIC INTERPRETIVE LETTER FIL-34-94 (1994). The FRB, OCC, and FDIC combine to regulate virtually the entire U.S. banking system. JENNINGS, *supra* note 29, at 78; see Patrikis, *supra* note 242, at 80-96 (discussing particular provisions of FDIC derivatives guidelines).

244. 12 C.F.R. § 208 app. A (1994).

245. 12 C.F.R. § 567 (1994) (*amended by* 57 Fed. Reg. 33,441 (July 1992)).

246. 12 C.F.R. § 325 (1994).

247. Cunningham, *supra* note 19, at 154. The FRB requirements are a culmination of requirements agreed upon by supervisory authorities from twelve countries, in July of 1988. *Id.*; see BASLE SUPERVISORS COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988) (setting forth Basle capital requirements).

248. See Cunningham, *supra* note 19, at 154 (discussing operation of FRB's capital adequacy guidelines).

249. See 12 C.F.R. § 208, § 567 (assigning and comparing risk ratios). The FRB and OCC capital guidelines, for example, prohibit a risk to capital ratio greater than eight. *Id.* The FDIC guidelines in contrast, deem a bank to be well-capitalized only if it has a total risk-based capital ratio of ten or higher. 12 C.F.R. § 325. FDIC guidelines

the subject bank does not meet the appropriate standard, it becomes, the target of substantial restrictions.²⁵⁰

Derivatives enter the guideline picture because they are assets that banks must include in calculating risk to capital ratios.²⁵¹ Regulatory bodies currently classify many derivatives in categories reflective of greater risk when compared to the categorization of more stable instruments.²⁵² The inclusion of derivatives in a bank's asset base can therefore negatively affect the bank's risk to capital ratio.²⁵³ By assigning higher levels of risk to derivative instruments, the regulatory bodies can discourage their use and, thus, indirectly regulate derivatives markets.²⁵⁴

4. The OCC, FRB, and FDIC Derivatives Guidelines

Beyond capital guidelines, the Office of the Comptroller of the Currency ("OCC") has taken an additional step to control derivatives-related risks, by issuing bank guidelines on managing common derivative risks.²⁵⁵ The OCC issued the guidelines for

prescribe, however, that a bank is adequately capitalized if its ratio is eight or higher. *Id.*

250. 12 C.F.R. § 567. Under the OCC guidelines, a savings institution that does not meet the OCC standards must first submit a plan to the OCC describing how it will achieve compliance. *Id.* If the OCC does not approve the plan, the savings institution may not increase its assets and is also subject to any other restrictions the OCC chooses to impose. *Id.*

251. See 12 C.F.R. § 325 (discussing such derivative instruments as interest rate swaps, basis swaps, forward rate agreements, caps, collars, floors, and any other instrument that gives rise to similar credit risks); 12 C.F.R. § 208 (including in FRB guidelines, swaps, forward rate agreements, interest rate swaps, currency options, and any other instrument that gives rise to similar credit risks). For a thorough discussion of swap treatment under the guidelines, see Ernest T. Patrikis, *Federal Reserve Capital Adequacy Guidelines as Applied to Swaps*, THE SWAP MARKET IN 1990 (Practicing Law Institute, Corporate Law and Practice Course Handbook Series No. B4-6923, 1990).

252. See Cunningham, *supra* note 19, at 158 (noting that interest rate and exchange rate contracts are subject to risk weight as high as fifty percent). In contrast, bank assets such as claims on governmental bodies or assets secured by collateral, are assigned risk weightings of zero to twenty percent. *Id.* at 156.

253. *Id.* at 154-58. Because higher risk assets carry lower values in calculating the banks quantity of capital, the overall ratio of assets to capital will be lower if risky assets comprise the banks portfolio. See *id.* (discussing risk weighting of assets and calculation of asset to capital ratios).

254. See Frederick D. Limpan, *New Risk-Based Capital Guidelines Will Change Banks' Future*, 107 BANKING L.J. 3 (1990) (predicting that bank use of zero percent weighted risk assets will increase while use of higher risk assets will decrease as result of capital guidelines).

255. OFFICE OF THE COMPTROLLER OF THE CURRENCY, RISK MANAGEMENT OF FINANCIAL DERIVATIVES, BANKING CIRCULAR No. 277 (1993) [hereinafter CIRCULAR 277]. The

the purpose of notifying banks that they need to know their risk, and be able to manage it.²⁵⁶ The derivatives guidelines address and recommend management procedures²⁵⁷ to reduce each of the six types of derivative inherent risks.²⁵⁸ The derivatives guidelines also address issues of capital adequacy²⁵⁹ and accounting disclosure.²⁶⁰ After further study of these risks, the OCC recently updated the original guidelines with examiner guidance and examination procedures.²⁶¹

In addition to requiring banks to analyze their own risk positions, the OCC derivatives guidelines require banks to analyze risk from the position of other parties to derivatives transactions.²⁶² Under the guidelines, management must identify

banking industry has not reacted negatively to the guidelines in large part because of substantial existing compliance with the guideline recommendations. See Joanne Morrison, *Bank Examiners to Get Stringent Guidelines for Structured Note Investments*, BOND BUYER, Oct. 24, 1994, at 2 (quoting OCC's senior deputy, Douglas Harris, as stating, "the majority of banks examined are in compliance").

256. Morrison, *supra* note 255, at 2.

257. CIRCULAR 277, *supra* note 255, at 3. The guidelines require banks to implement for example, comprehensive written policy procedures governing the use of derivatives after having subjected such procedures to senior management approval. *Id.* Under the guidelines, if a bank advises a customer against a particular purchase and the customer makes the purchase anyway, the bank must specially document the transaction. *Id.* Amongst the guidelines' recommendations are stringent risk measures and limits, operational controls, and increased use of netting agreements. *Id.* at 8-9, 11, 13-14.

258. See generally CIRCULAR 277, *supra* note 255 (discussing management principles for market, credit, liquidity, operational, systemic, and legal risk issues).

259. CIRCULAR 277, *supra* note 255, at 14.

260. *Id.* at 15-16.

261. OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK, RISK MANAGEMENT OF FINANCIAL DERIVATIVES 1 (1994). The updated procedures give examiners more detailed guidance in assessing a financial institution's expertise in managing derivatives risk and ability to use derivatives in a safe and sound manner. *Id.* at 1. For example, under guidance from the handbook, financial institution boards of directors should review any significant changes in derivatives policy and should generally encourage the use of netting agreements. Patrikis, *supra* note 242 at 148. The examiner guidance and procedures deem lack of an adequate risk control functions relative to levels of derivatives activities to be an unsafe and unsound banking practice. *Id.* at 148-49. Dealers and active position-takers are subject to even more stringent standards in risk control areas. *Id.* at 144. The OCC has also issued a question and answer bulletin answering many questions concerning the OCC's risk management guidelines. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULLETIN NO. 94-32, QUESTIONS AND ANSWERS FOR BC-277: RISK MANAGEMENT OF FINANCIAL DERIVATIVES (1994). The Question and Answer release provides a basis explanation of derivatives related risks and then provides further clarification of Circular 277. *Id.*

262. CIRCULAR 277, *supra* note 255, at 12, 13; see Patrikis, *supra* note 243 (discussing particular OCC derivative guideline requirements).

whether proposed transactions are consistent with counterparty policies and procedures known to the financial institution²⁶³ and how the impact of the proposed transactions will affect the financial condition of the counterparty.²⁶⁴ After ensuring the customer's understanding of derivative-related risks, the bank must periodically update its analysis of the counterparty's creditworthiness.²⁶⁵ Finally, before entering into the proposed transaction, the bank must reasonably assure itself that the counterparty has the legal and regulatory authority to proceed.²⁶⁶ Should the customer desire to proceed against bank recommendations, the guidelines suggest that the bank document its own analysis and information it provided to the customer.²⁶⁷

After the OCC issued derivatives guidelines, the FRB followed suit with its own set of guiding principles to assist its examiners in the regulation of derivatives.²⁶⁸ The FRB was particularly concerned that banks were selling complex risky financial instruments to unsophisticated and unsuited investors.²⁶⁹ Like the OCC guidelines, the FRB guidelines require banks to ensure that their counterparties, and the banks engaging in the derivatives transaction, understand accompanying risks.²⁷⁰ The FRB guidelines do not, however, require documentation of customer orders made in contravention to bank recommendations.²⁷¹

Finally, the FDIC has issued guidance to its bank examiners for determining whether banks are using derivatives appropriately.²⁷² Similar to the OCC and FRB guidelines, the FDIC also

263. CIRCULAR 277, *supra* note 255, at 11.

264. *Id.* at 12.

265. *Id.*

266. *Id.*

267. *Id.*

268. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, EXAMINER GUIDELINES SR 93-69 (1993) [hereinafter SR 93-69]. The FRB's guidelines are similar to the OCC guidelines except that the FRB guidelines do not require specific risk management techniques. Claudia Cummins & Robert M. Garsson, *Fed To Give Examiners Guidelines on Swaps*, AM. BANKER., Dec. 8, 1993, at 1.

269. See Garsson, *supra* note 268, at 1 (noting that Federal Reserve governor Susan M. Phillips stated that Federal Reserve wanted to make sure that banks were selling derivatives to sophisticated customers).

270. Patrikis, *supra* note 242, at 8.

271. See Lynn Stevens Hume, *Fed Gives Bank Examiners Risk Management Policies For Trading Activities, Including Derivative Products*, BOND BUYER, Jan. 5, 1994, at 6 (contrasting requirements of OCC guidelines against those of FRB).

272. FEDERAL DEPOSIT INSURANCE CORPORATION, INTERPRETIVE LETTER No. 94-94,

requires that banks must understand the risks involved with their derivative investments.²⁷³ The FDIC guidelines require banks to develop risk parameters expressed in terms of worst case scenarios, in order to aid management in deciding how to best treat the bank's derivatives holdings.²⁷⁴

5. Additional Regulatory Influences

Beyond statutory regulation and supervisory guidelines, several other agencies significantly influence the use of derivatives.²⁷⁵ The Financial Accounting Standards Board²⁷⁶ in cooperation with the Federal Financial Institutions Examination Council²⁷⁷ ("FFIEC") has made contributions to disclosure issues with regard to derivatives.²⁷⁸ Work done by the International

(May 18, 1994) [hereinafter FDIC No. 34-94]. The FDIC derivatives guidelines focus on the examination of financial institutions that are end-users of derivatives. Patrikis, *supra* note 242, at 81-82. Under the guidelines, FDIC examiners review the risks associated with a particular financial institution's derivative activities to determine whether a full institution examination is necessary. *Id.* at 82.

273. Jeffrey L. Seltzer, *The Role of the Board of Directors and Senior Management in the Derivatives Business*, in *MANAGING RISK EXPOSURE IN DERIVATIVES*, at 5 (PLI Corporate Law and Practice Course Handbook Series No. B4-7089, 1994). The FDIC issued the examiner guidelines not to discourage prudent risk taking, but rather, to ensure that acceptable management expertise accompany bank derivatives transactions. *FDIC Issues Examiner Guidance on End-users of Derivatives Products*, 62 *Banking Rep.* (BNA) No. 23, at 984 (June 6, 1994).

274. FDIC No. 34-94, *supra* note 272, at 17. In conducting their preliminary examination, the FDIC guidelines instruct bank examiners to consider a bank's market risk, credit risk, liquidity risk, operating risk, legal risk, settlement, and interconnection (systemic) risk before determining the necessity of a full examination. *Id.* at 18; see *FDIC Issues Examiner Guidance on End-users of Derivatives Products*, *Banking Rep.* (BNA) No. 23, at 984 (June 6, 1994) (further discussing requirements of FDIC No. 34-94).

275. See Cunningham, *supra* note 19, at 138-39 (discussing derivatives-related efforts of International Swaps and Derivatives Association and Federal Financial Institutions Counsel).

276. See *supra* note 189 (discussing role of Financial Accounting Standards Board).

277. 12 U.S.C. § 3301 (1988 & Supp. V 1993) Section 3301 describes the purpose of this Federal Counsel as:

[to] prescribe uniform principles and standards for the Federal examination of financial institutions by the Office of the Comptroller of the Currency, the Federal Deposit Insurance corporation, the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank board, and the National Credit Union Administration and make recommendations to promote uniformity in the supervision of these financial institutions. The Council's actions shall be signed to promote consistency in such examination and to insure progressive and vigilant supervision.

Id.

278. Cunningham, *supra* note 19, at 169.

Swaps and Derivatives Association²⁷⁹ ("ISDA") has resulted in standardized agreements that certain derivative transaction participants may use to ensure the legality and efficiency of their transactions.²⁸⁰

In seeking to enhance disclosure in connection with derivative financial instruments, FASB issued statement number 119.²⁸¹ The statement, entitled "Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments," seeks to accomplish not only better disclosure standards for derivatives²⁸² but also to make general disclosure with regard to fair value of financial instruments.²⁸³ Issued in early October 1994, the statement aimed to achieve these two goals in time for year-end financial reporting.²⁸⁴

The FASB Statement prescribes that with respect to certain derivatives, entities shall disclose certain information that general accounting principles did not require.²⁸⁵ Such new information includes the amount of capital invested in derivatives and on what terms.²⁸⁶ The disclosure must include discussion of credit and market risks pertaining to subject financial instruments, the cash requirements of those instruments, and applicable accounting policies.²⁸⁷ Disclosures should also distinguish between derivatives held for trading verses other purposes.²⁸⁸ The statement further encourages entities to disclose quantita-

279. See *supra* note 190 (discussing history and role of International Swaps and Derivatives Association).

280. See Cunningham, *supra* note 19, at 138-42 (discussing historical and operational aspects of ISDA master agreements).

281. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT NO. 119, DISCLOSURE ABOUT DERIVATIVE FINANCIAL INSTRUMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS (1994) [hereinafter FASB 119].

282. *Id.* at summary.

283. *Id.*

284. FASB Issues Final disclosure Standards For Derivative Instruments, BNA's Banking Rep. (BNA) at 1 (Oct. 10, 1994), available in Westlaw, BNA-BNK database.

285. *Id.* The statement applies to derivatives, standards that FASB Statement 105 does not already encompass within its requirements. *Id.*; see FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT NO. 105, DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK (1990) (setting forth disclosure standards pertaining to financial instruments containing risk not disclosed on balance sheets).

286. FASB 119, *supra* note 281, at 4.

287. *Id.* at 4-5.

288. *Id.* at 4. The new disclosure standards specifically require reporting of the average fair value of derivatives held for trading together with losses or gains secured from those derivatives. *Id.* With regard to derivatives held for other purposes than

tive information that would be useful in contrasting stated objectives in holding the instruments against the actual results of those holdings.²⁸⁹

The International Swaps and Derivatives Association has also made contributions to developing standardized documentation with regard to derivatives transactions.²⁹⁰ Beginning in 1985, the ISDA issued publications containing standardized codes and wording to be used by derivative transaction participants.²⁹¹ The ISDA's standardized wording agreements became known throughout the industry as master agreements,²⁹² and by 1993, the ISDA had published a set of master agreements and a user's guide explaining how to use them.²⁹³ Derivative transaction participants now use the agreements more than any other type of documentation.²⁹⁴

The ISDA publications²⁹⁵ aim to facilitate netting across dif-

trading, the entity must disclose the purpose for its holding the instrument and the expected gains or losses resulting therefrom. *Id.* at 4-5.

289. Patrikis, *supra* note 251, at 169-74. The FFIEC is also considering a proposal to revise reports that commercial banks must file with regard to their income position and overall financial condition. *Id.* at 97. The FFIEC has, however, deferred implementation of its proposal until March 31, 1995 in order to give the FASB time to coordinate its proposals. *Id.* The FFIEC proposal would require banks to report a single net credit exposure across all their derivatives contracts, taking into account netting agreements. *Id.* The proposal would also require further breakdown of monies invested in derivatives by contract type and gross fair value of derivative instruments. *Id.*

290. Cunningham, *supra* note 19, at 132-33.

291. *Id.* at 13.

292. Cunningham, *supra* note 19, at 139. Master agreements are standardized derivative contracts that the ISDA has developed over a period of years and published for industry use. *Id.* Prior to the development of these standardized contracts, typical OTC derivative documentation consisted of 15 to 25 page agreements for each individual transaction. *Id.* at 138. Because many of the agreements contained standardized words and phrases, master agreements began to materialize. *Id.* The formation of master agreements has been a transnational effort involving many parties. See Richard Waters, *ISDA Adopts Agreement*, FIN. TIMES, June 17, 1992, at 32 (noting ISDA's recognition of efforts by hundreds of participants from Europe, Japan, and United States in contributing to development of master agreements).

293. Cunningham, *supra* note 19, at 139.

294. Christopher L. Culp, *A Hidden Threat Lurks In Derivatives Legislation*, AM. BANKER, June 16, 1994, at 26. More than 70% of swaps dealers utilize master agreements in their transactions. Waters, *supra* note 292, at 32. In total, more than ninety percent of all OTC derivative transactions use the ISDA master agreements. *Id.*

295. See Cunningham, *supra* note 19, at 139 (discussing extensive list of ISDA master agreement publications and accompanying user's guides). For a detailed discussion of how ISDA master agreements work, see Joshua D. Cohn, *ISDA Master Agreements: 1992 and 1987 Versions Described and Compared, 1993 Pending Issues*, in SWAPS AND OTHER

ferent product types,²⁹⁶ and documentation of multiple derivatives transactions under one master agreement.²⁹⁷ In doing so, the agreements reduce derivatives-related risk by promoting legal certainty²⁹⁸ and lower credit risk.²⁹⁹ The master agreements, although not eliminating all risk,³⁰⁰ have become widely known as risk reducing mechanisms for derivatives transactions.³⁰¹

F. *Financial Loss Under the Current Regulatory System*

Under the current regulatory system, investors have incurred a variety of substantial financial losses.³⁰² Losses by large U.S. companies measuring in the hundreds of millions of dollars have been reported by Merrill Lynch, Salomon Brothers, Bankers Trust, J.P. Morgan, Proctor & Gamble, Gibson Greetings, George Soros, and Kidder Peabody.³⁰³ Even larger losses have

DERIVATIVES IN 1993 (PLI Corporate Law and Practice Course Handbook Series No. B4-7033, 1993).

296. See *supra* note 150 (discussing netting).

297. Cunningham, *supra* note 19, at 139.

298. Robert Rice, *Business and the Law: A Question of Standards - Robert Rice on Resistance to Further Regulation of the Derivatives Industry*, FIN. TIMES, Nov. 22, 1994, at 20. Master agreements ensure the enforceability of netting arrangements by providing standard provisions that have already been determined to be legally enforceable. *Id.*; see *supra* notes 158-60 and accompanying text (discussing legal risk).

299. Aaron Pressman, *Quick Study: Master Agreement Can Reduce Risk, Save Time with Multiple Swaps*, BOND BUYER, May 25, 1994, at 6. By facilitating netting and its legal enforceability, master agreements lower credit risk because the parties may take advantage of offsetting transactions in the event of counterparty default. *Id.* Master agreements also reduce credit risk by, for example, allowing a party to terminate the agreement in the event of counterparty bankruptcy, thus eliminating the possibility that the party would be liable to the debtor without corresponding responsibilities by the debtor. Robert M. McLaughlin, *Risks in Derivatives Products Are Substantial But Manageable*, AM. BANKER, Oct. 17, 1994, at 30; see *supra* notes 139-49 and accompanying text (discussing credit risk).

300. Denis M. Forster, *Standard Swaps Agreements Don't Insulate Users from Risk*, AM. BANKER, June 13, 1994, at 20. Even the best documents cannot eliminate all derivatives risk. *Id.* Although master agreements have simplified many contractual issues, they still remain complex and derivatives users should be prepared to resolve many critical issues through negotiation rather than through standardized agreements. *Id.*

301. Pressman, *supra* note 299, at 26.

302. Greenwald, *supra* note 20, at 54; see Waldman, *supra* note 2, at 1040 (describing many derivatives-related losses).

303. *Id.* at 1040. Merrill Lynch lost US\$377 million, Solomon lost US\$250 million, Bankers Trust lost as much as US\$389 million, J.P. Morgan lost US\$100 million, Proctor & Gamble Co. lost US\$157 million, Gibson Greetings lost US\$16.7 million, George Soros lost \$600 million, and Kidder Peabody lost US\$25.5 million. *Id.*

been reported by Japanese investors.³⁰⁴ Showa Shell Sekiyu K.K. for example, lost US\$1.59 billion, Kashima Oil lost US\$1.5 billion while Toyota lost US\$935 million.³⁰⁵ British multinational Allied-Lyons and German Klockner & Company KgaA and Metallgesellschaft AG lost a combined total of almost US\$2 billion investing in oil and currency derivative contracts.³⁰⁶ Most recently, Britain's oldest investment firm, Barings Bank, suffered financial collapse after a derivatives trader lost an estimated US\$1 billion in unauthorized trading.³⁰⁷

Although corporations have incurred most of the high profile losses, derivatives-related troubles have also struck municipalities and mutual funds.³⁰⁸ Orange County California lost over US\$2 billion of a US\$7.4 billion investment³⁰⁹ and subsequently filed for bankruptcy protection.³¹⁰ On a smaller scale, Maple Grove, a Minneapolis suburb lost US\$1.4 million on a US\$5 million investment.³¹¹ A small college in Odessa Texas lost half of its US\$22 million investment to derivatives, forcing the college to raise tuition, and the local community to raise property taxes.³¹² Mutual funds have also been big derivatives losers, as PaineWebber, Kidder Peabody, and BankAmerica combined to lose US\$500 million to derivatives in 1994.³¹³

304. Waldman, *supra* note 2, at 1040.

305. *Id.* at 1041.

306. *See id.* at 1041-42 (discussing individual losses and US\$1.9 billion bailout by Metallgesellschaft's creditors to keep it from entering bankruptcy).

307. *See* Richard W. Stevenson, *Markets Shaken As British Bank Takes Big Loss*, N.Y. TIMES, Feb. 27, 1995, at A1 (discussing derivatives trader's huge losses resulting from unauthorized derivatives transactions).

308. Greenwald, *supra* note 20, at 54.

309. *See supra* note 7 (discussing Orange County losses).

310. *Id.*

311. Greenwald, *supra* note 20, at 54. Maple Grove is a small community with a population of approximately 40,000. *Id.* Other municipalities have also lost large sums to derivative investments. *Little Action Expected on Derivatives*, Gannet News Service, Jan. 5, 1995, available in LEXIS, News Library, CURNWS File. Senator Barbara Boxer [D-Cal.] noted losses of US\$50 million by the Louisiana state pension fund, US\$90 million by the Florida state treasury, and 20% of a Minnesota investment pool that had served 20 cities. *Id.*

312. *Id.*

313. *Id.*

II. FUTURE OVERSIGHT OF DERIVATIVES MARKETS:
CONGRESSIONAL, REGULATORY, AND
TRANSNATIONAL APPROACHES

The losses related to derivative financial instruments have attracted the attention of Congress, federal regulators, and private industry representatives.³¹⁴ Although all agree that derivatives present new challenges and dangers to world financial markets,³¹⁵ they do not all agree as to the best way to approach derivatives-related problems.³¹⁶ Several congressmen have suggested new legislation while regulators and industry representatives oppose the idea.³¹⁷ In opposing prospective legislative changes, governmental agencies and industry representatives have offered alternative agendas to bring about better regulatory oversight.³¹⁸

314. Zaitzeff, *supra* note 8, at B9. A Representative commented on Orange County's losses, stating, "Washington's failure to provide adequate oversight of the derivatives market was at the heart of this week's (Orange county) bankruptcy filing." *Leach Says House Banking Ready to Take on Derivatives, Powers, and Consolidation*, Management Briefing (BNA) at 1 (Dec. 12, 1994). Leach also asked, "Where was the Commission? Where was Treasury? Where was Congress?" *Id.* In Leach's opinion, unless regulation of the derivatives business occurs soon, "an international trauma could erupt." John Hanchette, *House, Senate Banking Chairmen Go After Exotic 'Derivatives'*, Gannet News Service, Jan. 3, 1995, available in LEXIS, News Library, CURNWS File.

315. Zaitzeff, *supra* note 8, at B9.

316. *Id.*

317. *Id.* The SEC has stated that it will not seek congressional approval for increased oversight of derivative instruments. Aliza Fan, *No New Limits Needed on Derivatives, Administration Officials Tell Senators; Senate Banking Committee Hearing On The Financial Derivatives Market*, OIL DAILY, Jan. 6, 1995, at 3. Alan Greenspan, Chairman of the Federal Reserve Board, instructed Congress not to use the Orange County bankruptcy and other recent losses as an excuse to pass unneeded derivatives legislation. *Greenspan Attacks Laws On Derivatives*, BUFFALO NEWS, Jan. 5, 1995, at 1. As of December 12, 1994, no federal regulator had stated that its authority was inadequate and that legislation was necessary. *Swaps and Other Derivatives: Regulatory and Legislative Developments*, S&P'S REV. OF B'NG. & FIN. SERV., Dec. 12, 1994, at 117.

318. *Derivatives Legislation Depends on Regulators, Fed Official Says*, Pens. & Ben. Rep. (BNA) at 1 (Jan. 19, 1995), available in LEXIS, BNA Library, BNAPEN File. Federal Reserve Board Governor Susan Phillips recently stated that the progress of regulators in regulating derivatives will be a key factor in determining whether Congress passes new derivatives legislation. *Id.* For examples of current regulatory efforts, see Joanne Morrison, *Levitt Says That Delayed Derivatives Guidelines Will be Ready by Dec. 12*, BOND BUYER, Nov. 15, 1994, at 5 (noting that SEC, in cooperation with securities industry representatives, is drafting voluntary derivatives standards in an effort to stave off congressional action that could require SEC to step up its regulation of derivatives affiliates of securities firms and investment companies). The Federal Reserve Bank of New York, has nearly completed a first draft of a voluntary code of conduct for participants in derivatives markets. William Acworth, *Derivatives SRO Urged By Fed Counsel*, INSURANCE ACCOUNTANT, Jan. 30, 1995, at 3. The International Swaps and Derivatives Association,

Derivatives guidelines and regulatory principles are also developing on a global level, as transnational agencies and national regulators strive for cooperation in approaching derivatives-related risks.³¹⁹

A. *U.S. Congress Contemplates Legislative Action to Combat Derivatives Related-Risks*

Congress has not ignored³²⁰ mounting derivatives losses.³²¹ In addition to holding hearings to determine whether derivatives could pose a threat to investors, several congressmen have proposed derivatives-governing legislation.³²² New legislation to restrict derivatives use, promises to be a popular topic for debate in the 1995 Congress.³²³

Public Securities Association, Securities Industry Association, New York Clearing House, Foreign Exchange Committee and Emerging Markets Traders Association are also working with the New York Federal Reserve bank to establish the code. *Id.* The National Association of Securities Dealers also plans to issue sales practice rules for government securities dealers, including those engaged in selling derivatives. *NASD Delays Final Sales Practice Rules Until March*, Reuters Newswire, Jan. 11, 1995, available in Westlaw, INT-NEWS Database.

319. *See, e.g.*, Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board, Release No. IS-642, 56 S.E.C. Docket 759 (Mar. 15, 1994) [hereinafter Joint Statement] (establishing cooperation between the SEC, CFTC, and SIB in developing regulatory framework to oversee derivatives activities).

320. Peter C. Newman, *The Real Story Of An Insurance Giant's Fall*, MACLEAN'S, OCT. 24, 1994, at 40. After a leading American mutual fund announced that it had lost US\$950 million on derivatives, Dorgan compared using derivatives to handling nitroglycerine. *Id.* Dorgan noted that "putting your faith in derivatives, the most hyped-up and uncontrollable way to invest, is like hiring Daffy Duck to be your mutual fund manager." *Id.* Dorgan also stated that his bill would prevent "banks and other institutions with federal insurance from playing roulette in the derivatives market If an institution has deposits insured by the federal government, it should not be involved in trading risky derivatives for its own account." Dean Tomasula, *Bills on Swaps Oversight Making Investors Nervous*, AM. BANKER, June 24, 1994, at 24.

321. *See supra* notes 302-13 and accompanying text (discussing derivatives losses).

322. *See, e.g.*, H.R. 31, 104th Cong., 1st Sess. (1995) (Derivatives Safety and Soundness Supervision Act of 1995); H.R. 20, 104th Cong., 1st Sess. (1995) (Risk Management Improvement and Derivatives Oversight Act of 1995).

323. Joanne Morrison, *National*, BOND BUYER, Dec. 20, 1994, at 24. Outgoing House Banking Committee Chairman Henry B. Gonzalez [D-Texas] urged the new chairman to immediately hold Congressional hearings to discuss recent derivatives-related losses. *Id.* Gonzalez also sent a letter to Leach stating "you and I have worked together introducing legislation, 'the derivatives safety and soundness supervision act of 1994', and I hope we can continue in this effort to ensure that derivatives use does not threaten the viability of our financial system and the deposit insurance funds." *Id.* Representative Edward J. Markey [D-Mass.] recently vowed to reintroduce legislation, to reg-

1. Congressional Motivation for Change: Responding to the Losses

Congress has responded to derivatives losses to determine whether to take derivatives-governing legislative action.³²⁴ Comments made by congressmen from both congressional houses indicate congressional concern that derivatives could cause financial problems similar to the Savings and Loan crisis.³²⁵ Congressmen who aggressively favor derivatives governing legislation argue that the current regulatory framework and market forces are not sufficient to avoid impending financial disaster.³²⁶ They also contend that properly drafted legislation would not cause a shift of derivatives business to other markets.³²⁷

2. Bills in the House of Representatives

Derivatives legislation has been a popular topic for debate

ulate derivatives dealers, similar to proposals he made previously. *Congressional Agenda; Litigation Reform, Derivatives Regulation on Tap*, N.Y. L.J., Jan 19, 1995, at 5.

324. Michael Peltz, *Congress's Lame Assault On Derivatives*, INSTITUTIONAL INVESTOR, Dec. 1994, at 65.

325. *Derivatives Update—Further Losses Will Make Legislation More Likely*, INT'L BANKING REG., Oct 10, 1994, at 1; see *supra* note 12 (discussing congressional reactions to derivatives market risks).

326. *Markey Says Kidder Events Show Derivatives Oversight Needed*, 26 Sec. Reg. & L. Rep. (BNA) No. 32, at 1112 (Aug. 12, 1994). Representative Markey cited a rogue dealer's fraudulent trading in derivatives as evidence that increased derivatives regulation is necessary, in contradiction to regulators' and industry representatives' arguments for congressional restraint. *Id.* Markey also strongly objected to proposed rules by the National Association of Securities Dealers that would have provided sales practice guidance for derivatives dealers. *Derivatives: Tougher Rules Urged for Securities Dealers*, AM. BANKER, Oct. 25, 1994, at 18. He stated that the proposed rules have "serious deficiencies" and that they must be more stringent. *Id.* Representative Leach has stated, "[a]s helpful as derivatives are, they are a wild card in international finance" and "[t]here is no way to get a level playing field unless there is legislation. The Regulators have no power to achieve this without legislation." *Rep. Leach Pushes Derivatives Legislation; May Hold Glass-Steagall Hearings By Spring*, PENS. & BEN. REP. (BNA) (Feb. 9, 1995), available in LEXIS, BNA Database, BNAPEN File.

327. Joanne Morrison, *Congress Expected to Take Gingerly Approach Toward Derivatives, Aides Say*, BOND BUYER, Nov. 30, 1994. House Banking Committee aide Terri Miller stated, "We don't want to drive the business overseas. We're not prohibiters, we're not banners, we just want to make sure they're being used properly." *Id.* Markey commented on his proposed bill, H.R. 4745, by stating, "[t]his bill is not a radical restructuring of the derivatives market. It is focused laser-like on closing the real gaps that exist in the current regulatory framework." Steven Brostoff, *Markey Bill Would Regulate Derivatives Dealers*, NAT'L UNDERWRITER, July 25, 1994, at 5. Jerry Schober, a senior evaluator speaking for Congress' investigatory arm, the General Accounting Office, stated "[i]f regulation were to drive the business offshore, it would have been long gone by now." Ronald Fink, *Shadow Boxing*, FIN'L WORLD, Oct. 25, 1994, at 92.

in the House of Representatives where Representatives Henry B. Gonzalez [D-Texas] and Jim Leach [R-Iowa], have jointly³²⁸ and independently³²⁹ proposed legislation to overhaul the regulatory system governing derivatives.³³⁰ The latest versions of their bills, the Risk Management Improvement and Derivatives Oversight Act of 1995,³³¹ and the Derivatives Safety and Soundness Act of 1995,³³² are refined and expanded versions of bills submitted in previous terms.³³³ Representative Edward Markey [D-Mass.] has also proposed legislation to increase regulation of derivatives dealers.³³⁴

a. The Risk Management Improvement and Derivatives Oversight Act of 1995

The Risk Management Improvement and Derivatives Oversight Act of 1995³³⁵ ("House Bill 20") represents the latest attempt by Congress to pass derivatives governing legislation.³³⁶ House Bill 20 has gained substantially more support than previ-

328. H.R. 4503, 103d Cong., 2d Sess. (1994); see Zaitzeff, *supra* note 8, at B9 (noting that in 1994, Representatives Gonzalez and Leach jointly proposed Derivatives Safety and Soundness Supervision Act of 1994).

329. *Litigation, Glass-Steagall Reform are Topics on Congressional Agenda*, 1995 Daily Report for Executives (BNA) at 10 (Jan. 17, 1995). Before submitting a joint bill in 1994, Leach and Gonzalez had each submitted similar bills in the previous year. *Id.* For previous versions of the derivatives bills, see H.R. 3748, 103d Cong., 2d Sess. (1994), H.R. 4170, 103d Cong., 2d Sess. (1994), H.R. 4503., 103d Cong., 2d Sess. (1994). The unity of purpose shared by the two may be dissolving. See *Republican Victory Will Squash Threat of Legislation, Say Some*, INSTITUTIONAL INVESTOR, Nov. 14, 1994, at 1 (noting that both favor refined regulation of derivatives but, unlike Gonzalez, Leach does not view derivatives as a ponzi scheme). *But see Hill Hearings Loom?; Industry Braces for Fallout From Cap Corp Crisis*, NCUA WATCH, Feb. 6, 1995, at 1 (describing Leach and Gonzalez as being on same wavelength in regards to seeking specific derivatives regulation).

330. *Tighter Derivatives Regs Expected, Experts Say*, CFO ALERT, Feb. 13, 1995, at 8.

331. H.R. 31, 104th Cong., 1st Sess. (1995).

332. H.R. 20, 104th Cong., 1st Sess. (1995).

333. See *supra* note 329 (discussing previous Leach and Gonzalez bills).

334. See, e.g., Derivatives Dealers Act of 1994, H.R. 4745, 103d Cong., 2d Sess. (1994). Representative Markey expects to reintroduce similar legislation in 1995. Dominic Bencivenga, *Congressional Agenda; Litigation Reform, Derivative Regulation on Tap*, N.Y. L.J. Jan. 19, 1995, at 5; *BT Securities to Pay \$10 Million To Settle SEC, CFTC Fraud Charges*, 27 Sec. Reg. & L. Rep. (BNA) at 10 (Jan. 6, 1995) (discussing Markey's plans to reintroduce legislation based on Derivatives Dealers Act of 1994).

335. H.R. 20, 104th Cong., 1st Sess. (1995).

336. 141 Cong. Rec. H 163 (Jan. 11, 1995). On January 1, 1995, the Act was referred to the House Banking and Financial Services Committee, the House Commerce Committee and the House Agriculture Committee, where it is currently under consideration. *Id.*

ous derivatives bills.³³⁷ If successful, House Bill 20 would significantly affect derivatives markets.³³⁸

House Bill 20 sets forth several major objectives.³³⁹ First, the bill would establish a Federal Derivative Commission ("FDC") for the purpose of setting oversight standards federal regulators would apply in supervising financial institutions that engage in derivatives transactions.³⁴⁰ The FDC would also make recommendations for the purpose of promoting better risk management processes.³⁴¹ The bill specifically seeks to address problems related to counterparty, market, operational, legal, and systemic risks.³⁴² The Federal Derivatives Commission would also seek to enforce uniformity in the supervision of the subject financial institutions.³⁴³

Second, the bill would require stricter internal controls for banks involved in derivatives transactions.³⁴⁴ The FDC would set guidelines for effective senior management and oversight by

337. H.R. 20. The Act gained 140 co-sponsors, which far surpassed the levels of co-sponsorship of previous bills. *See, e.g.*, H.R. 4170, 103d Cong., 2d Sess. (1994) (no co-sponsors); H.R. 4503, 103d Cong., 2d Sess. 1994 (six co-sponsors). The Derivatives Dealers Act of 1994 also lacked support when only one congressman co-sponsored the bill. H.R. 4745, 103d Cong., 2d Sess. (1994).

338. *Tighter Derivatives Regs Expected, Experts Say*, CFO ALERT, Feb. 13, 1995, at 8 (noting that Leach's bill would create change in derivatives accounting, bankruptcy treatment and supervisory roles).

339. *See generally* H.R. 20 § 101 (discussing objective of bill to promote consistency in regulatory practices and to ensure progressive and vigilant supervision).

340. *See id.* (setting forth purposes of Act); *see also id.* § 103 (establishing Federal Derivatives Commission). The Federal Derivatives Commission would be composed of the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairperson of the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the Chairman of the Securities and Exchange Commission, the Chairman of the Commodity Futures Trading Commission, and the Secretary of the Treasury. *Id.* The Commission is to be chaired by the Chairman of the Board of Governors of the Federal Reserve System. *Id.*; *see id.* § 104 (establishing principles and standards of Commission and guidance in making recommendations for regulatory action).

341. H.R. 20 § 104(b)(1)(B).

342. H.R. 20 §§ 104(b)(1)(B),(G)-(H),(L); *see supra* notes 129-84 and accompanying text (discussing counterparty, market operational, legal, and systemic risks).

343. H.R. 20. Section 101 of House Bill 20 specifically states that the commission shall be designed to promote consistency in regulatory practices and to ensure progressive and vigilant supervision. *Id.* § 101. Section 108 creates a state liaison to encourage the application of uniform examination principles and standards by State and Federal supervisory agencies. *Id.* § 108.

344. *See* H.R. 20 §§ 201-03 (imposing new regulatory standards upon banks engaging in derivatives activities).

boards of directors to ensure that derivatives activities are being conducted in a safe and sound manner.³⁴⁵ The new standards would deem a bank to have engaged in unsafe or unsound banking practice thereby entitling the FDIC to revoke federal insurance of the bank³⁴⁶ if the bank is found to have had inadequate technical expertise with regard to the derivatives activities in which it has engaged.³⁴⁷ Non-U.S. banks engaging in derivatives activities would also be subject to increased scrutiny when seeking Federal Reserve Board approval for participation in U.S. markets.³⁴⁸

Title IV of House Bill 20, entitled the Derivatives Dealer Self-Regulation Act of 1995, would grant the Federal Reserve Board authority to decide whether or not to create a self-regulatory agency for the purpose of supervising derivatives dealers.³⁴⁹ In making that decision, the Board is to consider, amongst other factors, the effect such an agency would have on controlling derivatives-related risks,³⁵⁰ uniformity in regulation,³⁵¹ prevention of fraud and manipulation in derivatives markets,³⁵² and a general improvement in the supervision and functioning of deriva-

345. *Id.* § 104(b)(1)(D).

346. 12 U.S.C. § 1811 (1988 & Supp. V 1993).

347. H.R. 20 § 301. Section 1818 of 12 U.S.C. sets forth grounds upon which the Board of Directors of the FDIC may terminate federal insurance of a depository institution. 12 U.S.C. 1818. One such ground is if the institution is engaging in an unsafe or unsound practice. *Id.* § (2)(A)(i). Under Subsection 8, the depository institution is deemed to have engaged in an unsafe or unsound practice if it has "unsatisfactory asset quality, management, earnings, or liquidity." *Id.* § (8). House Bill 20 states that "[f]ailure of an institution-affiliated party engaged in derivatives activities to have adequate technical expertise may be deemed by the appropriate federal banking agency to constitute an unsafe or unsound banking practice within the meaning of section 8 of the Federal Deposit Insurance Act (12 U.S.C. § 1818)." H.R. 20 § 201(a).

348. 12 U.S.C. § 3105(d)(2)(A) (1988 & Supp. V 1993). Under Section 3105, the Federal Reserve Board may not approve an application of a non-U.S. bank for participation in U.S. markets unless the non-U.S. bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country. *Id.* House Bill 20 would add a qualification that if the non-U.S. bank is engaged in derivatives activities, the bank must also be subject in its home country to "comprehensive supervision and regulation for derivatives activities." H.R. 20 § 203.

349. H.R. 20 §§ 401-408; see *Derivatives Bill Called Good Start In Setting Regulatory Jurisdiction*, Pens. & Ben. Rep. (BNA) at 1 (Jan. 30, 1995) available in LEXIS, BNA Library, BNAPEN File (discussing New York Federal Reserve's proposed authority to establish self-regulatory association to supervise derivatives dealers).

350. H.R. 20 § 404(B)(2).

351. *Id.* § 404(B)(3).

352. *Id.* § 404(B)(8).

tives markets.³⁵³ House Bill 20 would not, however, require brokers and dealers that are already registered as securities or futures commission merchants, to join the self-regulating association.³⁵⁴

b. The Derivatives Safety and Soundness Act of 1995

The Derivatives Safety and Soundness Act of 1995³⁵⁵ ("House Bill 31") represents the culmination of efforts to bring about derivatives legislation by Representative Gonzalez [D-Texas].³⁵⁶ The act sets forth many of the same ideas as Leach's House Bill 20.³⁵⁷ Similar to House Bill 20, for example, House Bill 31 would seek to establish uniformity in standards of capital, accounting, disclosure, risk management, and suitability in the supervision of derivatives activities.³⁵⁸ House Bill 31, also like

353. *Id.* § 404(B)(9). The Board must also take into account the following factors: promotion of fair and orderly markets for derivative financial instruments; improvement in regulatory coordination among those responsible for supervision of derivatives dealers; closure of gaps and loopholes in the supervision of derivatives dealers; strengthened enforcement of rules and regulations applicable to derivatives dealers; and maintenance of high standards and qualifications for derivatives dealers. *Id.*

354. See H.R. 20 § 403(2) (defining derivatives dealer as not including any person that is registered as broker or dealer of securities or as futures commission merchant).

355. H.R. 20, 104th Cong., 1st Sess. (1995).

356. H.R. 20. House Bill 20 is the updated version of the Derivatives Safety and Soundness Supervision Act of 1994. H.R. 4503, 103d Cong., 2d Sess. (1994). The new bill encourages more disclosure and calls for international cooperation in regulating derivatives. *Digest*, WASH. POST, Jan. 5, 1995, at D9. The 1995 version of Gonzalez's derivatives legislation now adds insurance firms and securities companies to its subject matter in addition to the prior covered depository institutions. Compare H.R. 31 § 2(7) with H.R. 4503, 103d Cong., 2d Sess. § 2(7) (1994) (H.R. 31 adds insurance firms and securities firms to previous definition of financial institution found in the 1994 version of the Act). See *Gonzalez Offers Bill On Derivatives Oversight*, 22 Pens. & Ben. Rep (BNA) No. 5, at 340 (Jan. 30, 1995) (noting H.R. 31 addition). The 1995 version of the Derivatives Safety and Soundness Supervision Act includes, in part, the following in its definition of financial institution: any depository institution; any institution that is subject to the oversight of the Office of Federal Housing Enterprise or oversight of the Department of Housing and Urban Development; any federal home loan bank and the office of finance of the federal home loan bank; any broker, dealer, government securities broker, government securities dealer, municipal securities broker, or municipal securities dealer; any investment company; any investment adviser; any futures commission merchant, floor broker, commodity trading advisor, or commodity pool operator; any insurance company; and any affiliate of a depository institution. H.R. 20 § 2.

357. Zaitzeff, *supra* note 8, at B9. The similarity between the H.R. 20 and H.R. 31 could be due to previous cooperation between the two proposing Representatives. *Id.* The 1994 Derivatives Safety and Soundness Supervision Act of 1994 combines the independent approaches of Gonzalez and Leach. *Id.*

358. H.R. 31 § 101(a). The uniformity objectives set forth in Section 101 of House

House Bill 20, would specifically make legal, credit, market, and operational risks factors in determining whether regulated institutions are operating in compliance with regulatory requirements.³⁵⁹ Both bills also seek to tighten internal controls of financial institutions.³⁶⁰ Whereas House Bill 20 requires the FDC to establish guidelines regarding effective management oversight of derivatives activities,³⁶¹ House Bill 31 expressly sets forth management guidelines.³⁶² Finally, both bills state the same requirement that in order for the Federal Reserve Board to approve a non-U.S bank's operation in the United States, it must consider whether the derivatives activities of that bank are adequately supervised and subject to regulation in the bank's home country.³⁶³

House Bill 31 differs from House Bill 20 in several aspects.³⁶⁴ House Bill 31 seeks to enforce its objectives in an entirely different manner than the Leach bill.³⁶⁵ Whereas House Bill 20 would create a Federal Derivatives Commission composed

Bill 31 are similar to those set forth by Section 101 of H.R. 20. *See supra* note 343 and accompanying text (describing House Bill 20's objectives). The Gonzalez bill specifically seeks improvements in capital requirements, risk management, disclosure, and accounting standards in Sections 101(b)(A)-(B), (H), 102(a), and 102(c)(2). H.R. 20.

359. H.R. 31 § 101(b)(1)(A); *see* H.R. 20 § 104 (setting forth market, operational, credit, legal, and systemic risks as factors to be considered when deciding whether an institution using derivatives is in compliance with regulatory requirements).

360. *See* H.R. 20 § 104 (requiring Federal Derivatives Commission to establish management guidelines to be applied by financial institutions); H.R. 31 § 201 (expressly setting forth management guidelines financial institutions are to follow).

361. H.R. 20 § 104.

362. H.R. 31 § 201. An acceptable management plan must be approved by the board of directors and:

(1) ENSURE THAT SUCH ACTIVITIES ARE-

(A) conducted with appropriate oversight of the directors and the senior executive officers;

(B) conducted in a safe and sound manner; and

(C) consistent with the overall risk management philosophy and business strategy of the management of the institution; and

(2) establishes prudential standard for the management of the risks involved in such activities and a framework for internal controls with respect to such activities.

Id.

363. H.R. 20 § 203; *see* H.R. 31 § 204 (also requiring derivatives supervision in bank's home country).

364. Zaitzeff, *supra* note 8, at B9.

365. *See, e.g.*, H.R. 20 § 103 (establishing Federal Derivatives Commission to oversee derivatives in contrast to H.R. 31's delegation of oversight authority to existing regulatory bodies).

of leaders of major financial regulators,³⁶⁶ House Bill 31 would require regulatory bodies to work together to regulate derivatives.³⁶⁷ House Bill 31 would also place a premium on requiring the United States to take substantial steps towards derivatives regulation in the global context.³⁶⁸ The bill would specifically require the Chairman of the Federal Reserve Board and the Comptroller of the Currency to encourage transnational cooperation in adopting regulatory standards.³⁶⁹ House Bill 31 also differs from House Bill 20 in that it would order a study by the Comptroller General of the United States to inquire into speculative uses of derivatives.³⁷⁰

c. The Derivatives Dealers Act of 1994

The most recently proposed derivatives legislation by Representative Markey is the Derivatives Dealers Act of 1994³⁷¹ ("House Bill 4745"). House Bill 4745 narrowly focused on regulation of derivatives dealers.³⁷² Markey's proposed bill reflected his opinion that standards governing sales practices for derivatives are deficient.³⁷³

366. See *supra* note 340 and accompanying text (discussing formation of Federal Derivatives Commission proposed by H.R. 31).

367. H.R. 20 § 101; See *Gonzalez Offers Bill On Derivatives Oversight*, 22 *Pens. & Ben. Rep.* (BNA) No. 5, at 340 (Jan. 30, 1995) (noting that Gonzalez bill would require regulators to coordinate their efforts in regulating derivatives).

368. See *id.* (noting that Gonzalez bill would require United States to assume leadership position in promoting transnational coordination in supervision and regulation of transnational derivatives industry).

369. H.R. 20 § 402. Section 402 specifically states:

The Chairman of the Board of Governors of the Federal Reserve System and the Comptroller of the Currency shall encourage central banks, and regulatory authorities of the other industrialized countries to work toward maintaining and, where appropriate, adopting comparable supervisory standards and regulations, particularly capital standards for financial institutions engaged in derivatives activities.

Id.

370. H.R. 20 § 501.

371. H.R. 4745, 103 Cong., 2d Sess. 1994.

372. Steven Brostoff, *Markey Bill Would Regulate Derivatives Dealers*, NAT'L UNDERWRITER, July 25, 1994, at 5. Describing his bill, Markey stated "[t]his bill is not a radical restructuring of the derivatives market It is focused laser-like on closing the real gaps that exist in the current regulatory framework." *Id.*

373. See Joanne Morrison, *Suitability Rules Near for Bank Sales of Government Securities, Some Derivatives*, BOND BUYER, Nov. 23, 1994, at 3. A Markey aide stated "I think that the increased complexity of the product and the relationship of trust and confidence that develops between the customers and the dealers, makes derivatives a rather different product" *Id.* Markey has stated that rules for derivatives have "serious deficien-

House Bill 4745 would have addressed Markey's concerns by regulating derivatives dealers in a three-step approach.³⁷⁴ The bill first proposed to amend Section 3(a) of the Securities Exchange Act of 1934 by adding a paragraph to define "derivative" and "derivatives dealers."³⁷⁵ House Bill 4745 would then have required the registration of all derivatives dealers that had not already registered for other reasons.³⁷⁶ Once having registered, the dealers would have been subject to the SEC's authority to promulgate rules and regulations addressing the dealers's activities.³⁷⁷ The bill would have further required registered derivatives dealers to become members of a registered securities association, thus, submitting themselves to additional regulation.³⁷⁸ Association rules might, for example, focus on accurate record-

cies" and that therefore, the rules governing derivatives dealers ought to be tightened. *Derivatives: Tougher Rules Urged for Securities Dealers*, AM. BANKER, Oct. 23, 1994, at 18.

374. *US Legislative and Regulatory Activity Affecting Derivatives Markets*, FIN. REG. REP., July 1994, at 1 [hereinafter *Legislative Activity*]; see Peltz, *supra* note 12, at 65 (describing Markey's main focus as "plugging the regulatory gap that exists for derivatives affiliates of securities firms and insurance companies"). Markey has described his effort to extend SEC's regulatory jurisdiction as an effort to extend jurisdiction to "the regulatory black hole." *Id.* In contrast to the Gonzalez and Leach approaches, Markey believes that bank regulators already have sufficient power to regulate. *Id.* It is the regulation of dealers that presents a more urgent problem to Markey. *Id.* One writer quoted Markey as stating that "[w]e must ask senior management of the dealers in derivatives if it really understands what the 26-year-old-rocket scientists are doing with the firm's money." James Bethell, *Egg-heads With Attitude Drive Financial Wizardry*, SUNDAY TIMES, Oct. 2, 1994, at 1.

375. H.R. 4745 § 2. The Act defined derivative as any financial contract, or the instrument that derives its value from the value or performance of any security, currency exchange rate, or interest rate (or group of index thereof). *Id.* The Bill did not include exchange or NASDAQ-traded securities, futures, options on futures, or savings institution deposits. *Legislative Activity*, *supra* note 374, at 1. The Bill defined derivatives dealer as any person engaged in the business of buying, selling, or entering into derivatives for his own account. H.R. 4745 § 2. The definition did not include persons who trade for their own account, but not within their regular business. *Id.*

376. H.R. 4745 § 101.

377. Peltz, *supra* note 12, at 65.

378. 15 U.S.C. § 78 (1988 & Supp. V 1993). Section 15A of the Exchange Act, sets forth substantial requirements that a securities association must satisfy in order to qualify for registration under the 34 Act. *Id.* § 78(o). For example, the association must impose rules on its members that are:

designed to prevent fraudulent and manipulative acts and practice, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general to protect investors and the public interest.

Id.

keeping, sales practices, and internal risk management controls.³⁷⁹

Derivatives dealers affiliated with already registered dealers would also have been subject to the Markey bill's provisions.³⁸⁰ Section 101 of the bill required materially associated persons of brokers and dealers to file notice with the SEC of their status as such.³⁸¹ As an associated person the dealer would be indirectly regulated by its registered broker-dealer affiliate.³⁸²

The second step of House Bill 4745's approach would have been to aid the SEC in developing mechanisms by which to regulate derivatives dealers.³⁸³ The bill would have amended the Exchange Act³⁸⁴ to allow the SEC to require derivatives dealers to maintain detailed records of their activities and to submit those records to the SEC.³⁸⁵ Such reports would have enabled the SEC to evaluate the effects of the various dealers and associated persons on derivatives financial markets.³⁸⁶ The reports would also have given the SEC a first-hand look at the operational healths of the respective reporting dealers.³⁸⁷

Finally, House Bill 4745 would have imposed standards of financial responsibility upon derivatives dealers.³⁸⁸ Specifically, the bill would have amended the Exchange Act³⁸⁹ such that the SEC would have been required to monitor the total financial

379. *Legislative Activity*, *supra* note 374, at 1.

380. *See* H.R. 4745 § 101 (requiring associated persons of brokers and dealers to file notice with the SEC).

381. H.R. 4745 § 101(B). The Markey bill defines materially associated person as: any associated person of a broker, dealer, government securities broker, government securities dealer, municipal securities dealer, or derivatives dealer (other than a natural person) whose business activities are reasonably likely to have a material impact on the financial or operational condition of any such broker, dealer, government securities broker, government securities dealer, municipal securities dealer, or derivatives dealer, including on its net capital, its liquidity, or its ability to conduct or finance its operations.

Id. § 2; *see supra* note 376 and accompanying text (noting that SEC would have rule-making and enforcement authority over both affiliate and dealer).

382. *Legislative Activity*, *supra* note 374, at 1.

383. *Id.*

384. 15 U.S.C. § 77 (1988 & Supp. V 1993).

385. H.R. 4745 §§ 205-206. The records would contain, for example, the registered person's policies and procedures for controlling derivatives-related risks, records of derivatives trading activity, and any other information the SEC should require. *Id.*

386. *Legislative Activity supra* note 374, at 1.

387. *Id.*

388. H.R. 4745 § 203.

389. 15 U.S.C. § 77 (1934).

condition of a registered broker-dealer, including the condition of the broker-dealer's materially associated persons.³⁹⁰ Markey incorporated this proposal into House Bill 4745 in order to toughen regulations governing certain securities and insurance firms that have developed derivative-dealing affiliates that currently escape the jurisdiction of financial regulators.³⁹¹

3. The Senate Considers Derivatives Legislation

The Senate, although less active³⁹² in proposing derivatives legislation, did consider two substantial derivatives bills during the 1994 term.³⁹³ The Derivatives Supervision Act of 1994³⁹⁴ proposed by Senator Donald W. Riegle Jr. [D-Mich.], and the Derivatives Limitation Act of 1994³⁹⁵ proposed by Senator Byron L. Dorgan [D-N.D.], both attracted the attention of fellow congressmen, regulators, and the press.³⁹⁶ Neither of the Senate bills are before the current Congress, but future derivatives legislation may emulate their proposals.³⁹⁷

390. H.R. 4745 § 101.

391. *Legislative Activity*, *supra* note 374, at 1.

392. Zaitzeff, *supra* note 8, at B9.

393. See Olaf de Senerpont Domis, *Bankers Lobby Hard Against Bills to Curb Derivatives Activity*, AM. BANKER, Sept. 13, 1994, at 3 (discussing bills proposed by Senators Riegle and Dorgan).

394. S. 2291, 103d Cong., 2d Sess. (1994).

395. S. 2123, 103d Cong., 2d Sess. (1994).

396. See Lynn Stevens Hume, *Riegle's Derivatives Bill Is Far-Reaching, But May Not Go Anywhere In Congress*, BOND BUYER, July 20, 1994, at 32 (noting industry official's comment that Riegle's bill will provide guidance in drafting future legislation); see Stephen A. Davies, *Senate Derivatives Bill, Building on House Plans, Would Stiffen Regulation*, BOND BUYER, July 19, 1994, at 1 (noting Riegle's influential voice in drive to advance derivatives related legislation).

397. Olaf de Senerpont Domis, *Bankers Lobby Hard Against Bills to Curb Derivatives Activity*, AM. BANKER, Sept. 13, 1994, at 3. No further action is currently on Congress' schedule for the Riegle and Dorgan bills. *Id.* Senator Riegle, since introducing his bill has retired, but, industry officials have commented that his bill may guide Congress in the future. Lynn Stevens Hume, *Riegle's Derivatives Bill Is Far-Reaching, But May Not Go Anywhere in Congress*, BOND BUYER, July 20, 1994, at 32. Commentators noted, however, that substantial congressional action affecting derivatives is not unlikely in coming terms. *Id.*; see *Derivatives Disclosure Legislation Dead For This Congressional Session*, 63 Banking Rep. (BNA) No. 11, at 406 (Sept. 26, 1994) (correctly predicting that Congress would not pass derivative legislation in 1994 term, but noting that regulators have been alerted to Congress's resolve).

a. The Derivatives Supervision Act of 1994

The Derivatives Supervision Act of 1994³⁹⁸ ("Senate Bill 2291") compiled many ideas from the House bills while adding several new proposals.³⁹⁹ Similarly to the House bills, Senate Bill 2291 would have granted the SEC authority to oversee and regulate affiliates of derivatives dealers and insurance companies.⁴⁰⁰ Also similarly to other bills, Senate Bill 2291 would have required federal regulators to develop standards for capital adequacy, disclosure, and sales practices.⁴⁰¹ In the same spirit as House Bill 31, Senate Bill 2291 called for regulators to help develop transnational coordination of derivatives regulations.⁴⁰²

Senate Bill 2291, unlike previous proposals, took specific aim at eliminating speculative use⁴⁰³ of derivatives by certain regulated entities such as federally insured banks, credit unions, and government-sponsored agencies.⁴⁰⁴ The bill directly prohib-

398. S. 2291, 103d Cong., 2d Sess. (1994).

399. Zaitzeff, *supra* note 8, at B9; *see supra* notes 328-97 and accompanying text (discussing House bills).

400. S. 2291 § 7; *see Hume, supra* note 396, at 32 (discussing Senate Bill 2291's effects on derivatives dealers).

401. S. 2291 § 4. Senate Bill 2291 specifically required regulatory cooperation in addressing credit, market, operational, and legal risks associated with derivatives. *Id.* Section 10 of the Riegle bill also specifically addresses systemic risk by requiring federal regulatory agencies to promulgate, within 18 months of the bill's passage, regulations addressing a list of systemic risk-reducing items. *Id.* § 10; *see Hume, supra* note 396, at 32 (discussing similarity between Riegle bill and other derivatives legislation with regard to establishing derivatives standards).

402. S. 2291 § 8. Section 8 provides:

The Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System, in consultation with the Federal financial institutions regulatory agencies, shall encourage governments, central banks, and regulatory authorities of other industrialized countries to work toward maintaining and, where appropriate, adopting comparable supervisory standards, regulations, and capital standards in particular, for regulated entities and major dealers engaged in activities involving derivative financial instruments.

Id.; *see Hume, supra* note 396, at 32 (discussing transnational cooperation requirement of Riegle bill).

403. *See supra* notes 109-18 and accompanying text (discussing speculative uses for derivatives).

404. S. 2291 § 2. Under the bill, regulated entities are insured depository institutions; federal home loan banks; the Federal National Mortgage Association and any affiliate thereof; and the Federal Home Loan Mortgage Corporation and any affiliate thereof. *Id.* § 2(9). The involvement of banks in speculative derivatives trading is heavy. Anne Schwimmer, *Dorgan Bill Seen as Threat to Banks' Derivatives Use; Senator Would Ban Derivatives In Proprietary Trading*, INVESTMENT DEALERS' DIG., June 20, 1994, at 6. Three federally insured New York banks hold derivatives worth over US\$6 trillion. *Id.*

ited these types of institutions from using derivatives for speculative purposes.⁴⁰⁵ They would, however, have been able to use derivatives, upon federal regulatory approval, for hedging⁴⁰⁶ purposes only.⁴⁰⁷ Additionally, upon approval from the Federal Reserve Board, the institutions that the bill banned from using derivatives for speculative purposes, would have been able to establish subsidiaries to speculatively trade derivatives.⁴⁰⁸ As conditions for establishing such a subsidiary, the prospective subsidiary would no longer have been able to receive federal insurance,⁴⁰⁹ and would also have been subject to SEC jurisdiction.⁴¹⁰ Senate Bill 2291 would also have required banks and federally insured institutions to develop and maintain clear management policies.⁴¹¹ These policies would have been required to state institutional objectives in using derivatives, and the procedures each institution would employ to ensure that its use of derivatives is consistent with its stated objectives.⁴¹²

405. S. 2291 § 3(a). Section 3 prohibits regulated entities from purchasing, selling or engaging in any transaction involving a derivative financial instrument for the account of that entity. *Id.*

406. *See supra* note 61 (discussing hedging uses for derivatives).

407. S. 2291 § 3(c). Subsection 3(c) reiterates the prohibition in subsection (a) by stating: "Nothing in this section shall be construed to authorize a regulated entity, or any subsidiary of such entity, to purchase, sell, or engage in a transaction involving a derivative financial instrument for its own account for any speculative purpose." *Id.* § 3(c). Subsection 3(b) delineates the hedging use exception. *Id.* § 3(b). The section states in pertinent part:

A regulated entity may purchase, sell, or engage in any transaction involving a derivative financial instrument for the account of that entity for the purpose of engaging in a hedging transaction if such activity involves a category of derivative financial instruments approved by rule, regulation, or order of the appropriate federal financial regulatory agency for such purpose.

Id.

408. S. 2291 § 9.

409. *Id.* Section 9 specifically provides that a bank subsidiary may only engage in derivatives transactions if it is not federally insured. *Id.* This provision is consistent with Riegle's concern that taxpayer money may have to fund derivatives losses. *U.S. Bank Bill Would Protect From Derivatives Risk*, Reuters Newswire, July 18, 1994, at 1, available in Westlaw, INT-NEWS Database (quoting Riegle as stating, "derivative transactions are highly speculative and major losses put deposit insurance funds at great risk").

410. Hume, *supra* note 396, at 32; *see Riegle Introduces Derivatives Bill Requiring Affiliates, Greater SEC Role*, Sec. Reg & L. Rep., July 22, 1994, at 1027 (noting proposed legislation would require Federal Reserve Board to approve establishment of bank subsidiaries, and SEC would regulate activities of approved subsidiary). Institutions that were not affiliated with banks could enter into speculative derivatives transactions under the Bill. *Id.*

411. S. 2291 § 6.

412. *Id.* Section 6 requires that the institutions develop a management plan set-

b. The Derivatives Limitation Act of 1994

The Derivatives Limitations Act of 1994 ("Senate Bill 2123")⁴¹³ as proposed by Senators Byron L. Dorgan [D-N.D.] and Barbara A. Mikulski [D-Md.] is the narrowest of the congressional bills, aiming only to prohibit insured depository institutions and credit unions from engaging in certain types of activities involving derivative financial instruments.⁴¹⁴ Senator Dorgan has suggested regulation of derivatives with strong conviction⁴¹⁵ and thus, Senate Bill 2123, or a bill similarly addressing the risks derivatives impose on banks, may reappear during the 1995 congressional term.⁴¹⁶

Senate Bill 2123 is substantively similar to parts of Riegle's Senate Bill 2291.⁴¹⁷ Senate Bill 2123 begins with a general prohibition on the trading of derivatives by federally insured depository institutions,⁴¹⁸ while excepting hedging transactions from

ting forth: the purpose of the institution's investing in derivatives; how its holdings are consistent with an overall risk management plan; how the derivatives were acquired; the accounting methods used with respect to those derivatives; the level of management oversight, and the frequency with which senior management reviews the derivatives holdings. *Id.*

413. S. 2123, 103d Cong., 2d Sess. (1994).

414. Zaitzeff, *supra* note 8, at B9. The Dorgan bill is intended to ban banks from using derivatives in their proprietary trading activities. Anne Schwimmer, *Dorgan Bill Seen As Threat to Banks' Derivatives Use; Senator Would Ban Derivatives in Proprietary Trading*, INVESTMENT DEALERS' DIG., June 20, 1994, at 6. Like Senator Riegle, Dorgan drafted his bill to "ensure that banks don't have to use [federal insurance] to cover losses on derivatives trading for their own accounts." *Id.*; see *Hill Briefs*, NAT'L L.J.'S CONGRESS DAILY, May 18, 1994, at 1 (quoting Dorgan as saying before Congress, "What investors do with their own money is their own business. But, what they do with money insured by American taxpayers, is the business of Congress.").

415. See *supra* notes 320-27 and accompanying text (discussing congressional motivation in proposing derivatives legislation).

416. Robert A. Rosenblatt, *Orange County in Bankruptcy; Greenspan Indicates County Will Not Get Federal Help; Congress: Federal Reserve Board Chairman Says Paper Losses Occur Throughout The Economy and That The Markets "Are Adjusting Well To That"*, L.A. TIMES, Dec. 8, 1994, at A26. Senator Dorgan stated in that he will offer legislation in the 1995 congressional term barring banks from using derivatives to trade in their own accounts. *Id.*

417. See *supra* notes 398-412 and accompanying text (discussing provisions of Senate Bill 2291).

418. S. 2123 § 2. Section 2 provides, with exceptions, "neither an insured depository institution, nor any affiliate thereof, may purchase, sell, or engage in any transaction involving a derivative financial instrument of the account of that institution or affiliate." *Id.*; see *supra* notes 405-12 and accompanying text (discussing prohibitions on derivatives trading found in Senate Bill 2291).

the prohibition upon appropriate federal regulatory approval.⁴¹⁹ Senate Bill 2123 also permits derivatives trading for non-hedging purposes so long as such trading is conducted by affiliates of the insured institution that are separately capitalized and not federally insured.⁴²⁰ Senate Bill 2123, unlike Senate Bill 2291, does not offer broader proposals regarding regulatory cooperation in developing specific derivatives trading standards, or transnational cooperation.⁴²¹

B. Federal Regulatory and Private Responses to Derivatives

Private derivatives industry participants have opposed the idea of legislation as the answer to derivatives-related problems.⁴²² Financial regulators have joined the opposition in an attempt to dissuade Congress from passing what the regulators consider to be imprudent and unneeded legislation.⁴²³

419. S. 2123 § 2. The Riegle bill defines hedging transaction, as any transaction involving a derivative financial instrument if:

(A) Such transaction is entered into in the normal course of the institution's business primarily-

(I) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the institution; or

(II) to reduce risk of interest rate or price changes or currency fluctuations with respect to loans or other investments made or to be made, or obligations incurred or to be incurred, by the institution; and

(B) Before the close of the day on which such transaction was entered into (or such earlier time as the appropriate federal banking agency may prescribe by regulation), the institution clearly identifies such transaction as a hedging transaction.

Id. § 2(B).

420. S. 2123 § 2. Affiliates must also comply with rules, regulations, or orders of appropriate federal banking agencies. *Id.*; see *supra* note 409 and accompanying text (discussing similar provision in the Riegle bill); see also S. 2123 § 4 (amending Section 3 of the Bank Holding Company Act of 1956, 12 U.S.C. § 1842, to permit subsidiaries of banks to trade in derivatives so long as subsidiary is independently capitalized and not federally insured).

421. See S. 2291 §§ 8, 10 (requiring national and transnational regulatory agency cooperation in development of derivatives standards).

422. *Banking Figures*, INT'L BANKING REG., Jan. 9, 1995, at 8. Private agencies that champion derivatives causes such as the International Swaps and Derivatives Association are known for their confrontations with Congress. See *Bankers Hopeful A GOP congress Will Mean Expanded Powers, More Relief*, 1994 DAILY REP. FOR EXECUTIVES (BNA) No. 10, at 17 (Jan. 17, 1995) (noting strong opposition to derivatives legislation by banking and securities industries).

423. Zaitzeff, *supra* note 8, at B9. Regulators in the United States are unified with banking and securities industries against Congress. *Id.* Andrew C. Hove Jr., acting chairman of the Federal Deposit Insurance Corporation, in response to H.R. 4745, stated, "[w]e believe that appropriate supervision and risk control of financial institu-

Both groups cite actions they have already taken specifically to reduce and control derivatives-related risks, as reason to postpone or eliminate legislative proposals.⁴²⁴

1. Arguments Against Congressional Action

Parties opposed to new derivatives legislation argue that such legislation is not necessary for several reasons.⁴²⁵ One reason, they contend, is that the losses that have drawn attention to derivatives,⁴²⁶ have been due to bad investment planning and poor financial management, not the instruments themselves.⁴²⁷

tions' derivative activities can be achieved without additional legislation." *Markey Bill Would Regulate Derivatives Dealers*, NATIONAL UNDERWRITER (Life & Health/Financial Services ed.), July 25, 1994, at 5. Many industry participants are fearful of congressional action merely because it is difficult to predict what form legislation will eventually take. Peltz, *supra* note 12, at 65.

424. Lynn Stevens Hume, *Federal Regulators Say They Can Oversee Derivatives and Concerns Are Overstated*, BOND BUYER, Oct. 28, 1993, at 1. Regulators have stated that they have and are developing appropriate tools to deal with derivatives-related risks and that concerns about derivatives are "overblown." *Id.* One representative from the OCC, with respect to the prospect of new legislation, said "[w]e feel we have sufficient powers. More important, we've been exercising those powers." Peltz, *supra* note 12, at 65. SEC chairman Arthur Levitt told Congress, "[t]he commission is not persuaded that legislative changes are needed at this time to address pricing and liquidity issues raised by derivatives," and that the SEC was currently considering three changes it could achieve on its own without new legislative authority. *SEC's Levitt Lays Out Plan For Derivative Holdings*, INVESTMENT DEALERS' DIG., Oct. 3, 1994, at 41. Federal Reserve Board Governor John Laware told a conference on mutual funds' use of derivatives that further legislation in the derivatives area would be counterproductive because the existing regulatory scheme is sufficient. *Derivatives Survey Will Give Regulators Better Handle On Banking Industry Risks*, 63 Banking Rep. (BNA) No. 21, at 818 (Dec. 5, 1994). Laware also noted that investors have already begun pulling away from riskier mutual funds because of the funds's use of derivatives. *Id.*

425. Peltz, *supra* note 12, at 65. The SEC, for example, argues that there is no regulatory gap with respect to derivatives and that it has more power than many recognize. *Id.*

426. See *supra* notes 302-13 and accompanying text (discussing derivatives losses).

427. *Regulators Tell Senate Panel No Derivatives Legislation Needed Now*, 64 Banking Rep. (BNA) No. 2, at 67 (Jan. 9, 1995). Treasury Secretary Frank Newman, Federal Reserve Board Chairman Alan Greenspan, Securities and Exchange Commission Chairman Arthur Levitt, and Commodity Futures Trading Commission Chairman Mary Schapiro all testified before Congress in hearings held to examine derivatives problems, that no new legislation was needed because current derivatives losses are due to poor investment strategies. *Id.* SEC Chairman Levitt stated, "[d]erivatives did not cause the Orange County Pools' problems. The fault lies in a failed investment strategy involving the use of borrowed money for speculation." Tony Munroe, *Fed Chief Urges Senate Not to Make 'Mistake' of Regulating Derivatives*, WASHINGTON TIMES, Jan. 6, 1995, at B7. The Comptroller of the Currency stated that even though losses will occur from derivatives, "this is a period in which the banking industry is very strong." Joanne Morrison & Martha M. Canan, *Congress May Hold Hearings in Wake of California Pool's Derivatives*

The opposition to legislation urges that patience and better understanding of young derivatives markets will lead to better financial management and fewer financial losses.⁴²⁸

Another reason regulators and the derivatives industry oppose congressional action is because they fear the effect such action could have on markets in the United States.⁴²⁹ They argue that increased regulation will cause markets to quickly move offshore.⁴³⁰ Should that occur, they contend, the United States will lose a multi-billion dollar financial industry while investors will not receive any greater protection.⁴³¹

Some commentators that are opposed to legislation also doubt the ability of Congress to pass any legislation that could

Losses, BOND BUYER, Dec. 5, 1994, at 1. Another commentator stated "[d]erivatives aren't a pyramidal house of cards; in fact derivatives aren't dangerous at all. What's dangerous are the naive treasurers who delude themselves into believing that they are financial wizards, smarter than professional traders on the world's fastest markets." Thomas G. Donlan, *Fear of Derivatives May Be More Threatening Than Derivatives*, BARON'S, Dec. 5, 1994, at 62.

428. *Greenspan Opposes Legislation On Derivatives*, BALTIMORE SUN, Jan. 6, 1995, at 10C. Levitt likened derivatives to electricity in its early years, "dangerous if mishandled but bearing the potential to do tremendous good." *Id.* One commentator argued, "[h]eavy-handed legislative responses, like those already proposed to regulate derivatives use, ignore on-going efforts of banking regulators and the industry itself to analyze and minimize the systemic risks created by these sophisticated financial instruments." *GOP Takeover May Mean Turmoil for Muni Issues*, BOND BUYER, Nov. 10, 1994, at 1; see Joanne Morrison, *More Conservative Approach Is Likely For Derivatives After Losses In 1994*, BOND BUYER, Jan. 4, 1995, at 1 (noting that financial managers will most probably be less likely to use riskier derivatives after witnessing Orange County losses).

Some congressmen are balking at the idea of new legislation. See, e.g., *Regulators Tell Senate Panel No Derivatives Legislation Needed Now*, 64 Banking Rep. (BNA) No. 2, at 67 (Jan. 9, 1995) (noting opposition to derivatives legislation of Senators Phil Gramm [R-Texas], Richard Shelby [R-Ala.], Lauch Faircloth [R-N.C.], Robert Bennett [R-Utah] and Connie Mack [R-Fla.]).

429. Peltz, *supra* note 12, at 65. New York Federal Reserve Bank President E. Gerald Corrigan has noted that "[t]here are some dangers in the legislative approach, especially given the extraordinary complexities of these markets and the fact that they don't start at the Pacific and end at the Atlantic." *Id.*

430. *Fed To Issue Proposal To Address Capital Assessment Needs for Loan Securitization*, 64 Banking Rep. (BNA) No. 4, at 150 (Jan. 23, 1995). Federal Reserve Board Governor John Laware has stated that if Congress takes the conventional approach of writing a bill to solve derivatives problems, "we'll simply export this market to London or Frankfurt or Tokyo or someplace else." *Id.*

431. *Id.* Laware has described the movement of derivatives markets away from the United States as a "tragedy for U.S. capital markets." *Id.* One Wall Street firm that would be hit hard by legislation is Merrill Lynch. Leah Nathans Spiro, *Securities: On Wall Street: This Too Shall Pass*, Bus. Wk., Jan. 9, 1995, at 95. Approximately 30% of Merrill Lynch's US\$2 billion trading revenue in the first nine months of 1994 was attributable to derivatives. *Id.*

catch derivatives within an effective regulatory framework.⁴³² They argue that similar attempts have been made in Japan and these attempts' unequivocal failure should serve notice that the best approach to derivatives in the United States is not through federal legislation.⁴³³ The commentators argue that regulators and government must approach derivatives from a transnational perspective if they hope to contribute to the safety of global financial markets.⁴³⁴

Finally, some commentators opposed to congressional action argue that even current market regulators should hesitate before taking any derivatives-related action.⁴³⁵ They assert that market participants who participate in regulated markets may develop too much confidence in the regulation itself, and thus, not remain diligent in avoiding risks.⁴³⁶ The commentators contend that such a possibility is particularly likely with non-financial corporations.⁴³⁷

432. Gregory J. Millman, *Derivatives as Dump Trucks; They Are Risky, But They Haul Away the Refuse of Bad Government Policy*, WASH. POST, Dec. 18, 1994, at C2. One commentator stated that "regulation was pointless because 'we'll eventually be financial institutions headquartered on ships floating mid-ocean.'" *Id.* Another noted that "[a]tempting to legislate the regulation of products as complex as derivatives is rather like instructing a child to insert a square peg into a round hole. Despite the futility, an obedient child will try to make the peg fit, often with disastrous consequences for the peg." Steve H. Hanke, *The Protection Racket*, FORBES, Oct. 24, 1994, at 104.

433. Millman, *supra* note 432, at C2. One SEC official noted, "[i]f the Japanese haven't been able to do it with as tight a regulatory net as anybody, it's hard for me to envision how the U.S. with all the wonders of due process could write a rule that wouldn't be subject to some challenge." *Id.*

434. See, e.g., U.S. SECURITIES AND EXCHANGE COMMISSION, TESTIMONY OF BRANDON C. BECKER, DIRECTOR DIVISION OF MARKET REGULATION U.S. SECURITIES AND EXCHANGE COMMISSION, CONCERNING DERIVATIVE FINANCIAL INSTRUMENTS, BEFORE THE SUBCOMMITTEE ON ENVIRONMENT, CREDIT AND RURAL DEVELOPMENT COMMITTEE ON AGRICULTURE, U.S. HOUSE OF REPRESENTATIVES, (June 14, 1994) (noting SEC support of CFTC emphasis on interagency and international cooperation in addressing derivatives-related concerns).

435. *Regulator's Progress Will Determine Lawmakers' Actions, Fed's Phillips Says*, 64 Banking Rep. (BNA) No. 4, at 160 (Jan. 23, 1995). Former Treasury Undersecretary Robert Glauber noted that a cost of regulation is that the safety net will go where the regulators go. *Id.* SEC Commissioner Richard Roberts believes that the marketplace and not the SEC, should determine the success or failure of derivative products. Lynn Stevens Hume, *Success of Derivatives Products Is Better Left to the Marketplace*, BOND BUYER, May 2, 1994, at 5.

436. *Regulators' Progress Will Determine Lawmakers' Actions, Fed's Phillips Says*, 64 Banking Rep. (BNA) No. 4, at 160 (Jan. 23, 1995).

437. *Id.* Advocates of less regulation assert that better disclosure to shareholders will educate shareholders as to the importance of a decision to use derivatives. *Id.* Hav-

2. Federal Regulator and Private Action

While opposing legislative proposals, regulatory forces already in place have been and are continuing to take action to lower derivatives-related risks.⁴³⁸ The Federal Reserve Board⁴³⁹ ("FRB"), Office of the Comptroller of the Currency⁴⁴⁰ ("OCC"), and Federal Deposit Insurance Corporation⁴⁴¹ ("FDIC") have, for example, issued mandatory guidelines that banks and other financial institutions are to use when investing in derivatives.⁴⁴² Private organizations like the International Swaps and Derivatives Association⁴⁴³ have lowered the risks of using derivatives by developing standardized formats for derivatives transactions.⁴⁴⁴ Cross-border actions like the joint statement of cooperation between the Securities and Exchange Commission, the Commodities Futures Trading Commission, and the U.K.'s Securities and Investment Board have further attempted to lower derivatives-related risks.⁴⁴⁵

a. OCC, FRB, and FDIC Actions

The Office of the Comptroller, the Federal Reserve Board, and the Federal Deposit Insurance Corporation have taken several affirmative steps to ameliorate derivatives-related risks.⁴⁴⁶

ing become better informed, the shareholders can then fairly bear the risk of their investment. *Id.*

438. Zaitzeff, *supra* note 8, at B9. Comptroller of the Currency Eugene Ludwig stated before Congress that regulators have taken many of the steps current legislation proposes, and that legislative action is not necessary at this time. *Id.*

439. *See supra* note 186 and accompanying text (discussing Federal Reserve Board purpose and function).

440. *See supra* note 187 and accompanying text (discussing OCC function and purpose).

441. *See supra* note 242 and accompanying text (discussing FDIC function and purpose).

442. *See supra* notes 255-71 and accompanying text (discussing FRB and OCC derivatives guidelines).

443. *See supra* note 190 (describing International Swaps and Derivatives Association).

444. *See supra* notes 290-301 and accompanying text (discussing master agreements).

445. SEC, CFTC, U.K. Regulators Issue Statement On OTC Derivatives Oversight, INT'L BUS. & FIN. DAILY, Mar. 16, 1994, at D9.

446. Lynn Stevens Hume, *Fed Gives Bank Examiners Risk Management Policies For Trading Activities, Including Derivative Products*, BOND BUYER, Jan. 5, 1994, at 6. Derivatives guidelines issued by the FRB and the OCC are very similar to each other not only in the requirements they set forth, but also in their ultimate goal of lowering derivatives risks by ensuring that derivatives users understand the nature of their investments. *Id.*

Perhaps the highest profile regulatory action to date has been the issuance of derivatives guidelines by both the OCC and FRB to be applied to banking institutions.⁴⁴⁷ Because banks compose approximately seventy percent of the over-the-counter market in derivatives, these guidelines affect a large portion of derivative trading in the United States.⁴⁴⁸ Similar to proposed legislation,⁴⁴⁹ the guidelines seek to reduce risks associated with derivatives trading by prescribing procedures to manage the fundamental risks accompanying derivatives use.⁴⁵⁰ The FDIC has followed a similar path in developing special derivatives guidelines that its bank examiners are to follow when determining whether a bank is conducting business in a safe and sound manner.⁴⁵¹

The OCC, FRB, and FDIC have also included derivatives in their bank capital adequacy guidelines.⁴⁵² The inclusion of derivatives in capital adequacy guidelines has given these agencies

447. See *supra* notes 255-71 and accompanying text (discussing FRB and OCC derivatives guidelines).

448. Zaitzeff, *supra* note 8, at B9

449. *Id.* By requiring banks and other users to establish written policies regarding derivatives trading, as well as identification of fundamental risks, the guidelines aim at an objective of safety and soundness in the banking industry similar to the proposals of Representatives Gonzalez and Leach. *Id.*; see *supra* notes 335-69 (discussing provisions of Gonzalez and Leach proposals); see also *Agencies Plan New Capital Requirements on Derivatives*, BANKING POL. REP., Sep. 19, 1994, at 5 (noting that legislation sponsored by Gonzalez and Leach would convert into law, many of rules left to discretion of such regulatory bodies as OCC and FRB).

450. See *supra* notes 255-71 and accompanying text (discussing OCC and FRB derivatives guidelines).

451. See *supra* notes 272-74 and accompanying text (discussing FDIC examiner guidelines).

452. See *supra* notes 244-54 and accompanying text (discussing bank capital adequacy guidelines). The development of capital adequacy guidelines has also proceeded on a transnational level, as regulators worldwide are considering standards not only for capital but also for disclosure, accounting, and internal controls. *Derivatives, Oversight of Derivatives Activity Moving at Acceptable Pace, Fed's Phillips Says*, Daily Rep. for Executives (BNA) No. 25, at A184, Sept. 26, 1994. In 1993, work by the Bank for International Settlement's Basle Supervisory Committee resulted in a preliminary framework to assess the quantities of capital banks would need to cover market risk associated with traded debt, equity, and non-U.S. exchange. *Id.* Federal Reserve Board Governor Susan Phillips recently told a conference on global financial markets in Washington that the group is currently reworking its proposals, "a key aspect of which will be considering the use of banks' internal risk management models for determining regulatory capital." *Id.* In addressing the issue of developing a reliable system to be incorporated in the Basle framework, in order to measure the exposure of banks to the market risks of derivatives, Federal Reserve Board Governor John P. Laware stated that the OCC and FRB guidelines on derivatives should provide "a valuable checklist." *Fed's Laware Says U.S. Policy Toward Foreign Banks Is Paranoid, Protective*, INT'L BUS. & FIN. DAILY, Mar. 8, 1994, at D4.

a second method in addition to the derivatives guidelines,⁴⁵³ by which to regulate derivatives activity.⁴⁵⁴ By raising or lowering the amounts of capital that banks must provide to offset their derivatives activities, the OCC, FRB, and FDIC can discourage or encourage derivatives use.⁴⁵⁵

In addition to developing special capital requirements and guidelines for derivatives,⁴⁵⁶ the FRB has also sought to eliminate fraudulent derivatives transactions.⁴⁵⁷ In December 1994, for example, the FRB imposed a stiff penalty on a subsidiary of Bankers Trust, BT Securities, for having committed fraud in its dealings with Gibson Greetings Inc.⁴⁵⁸ The penalty consisted of the signing of a written agreement by the subsidiary requiring Bankers Trust to institute strict controls in its derivatives trading business.⁴⁵⁹ Under the agreement, the company had to institute strict standards for determining whether derivative type investments are appropriate for investors.⁴⁶⁰

453. See *supra* notes 446-54 and accompanying text (discussing derivatives guidelines).

454. See *supra* notes 251-54 and accompanying text (discussing capital adequacy guideline effect on derivatives use).

455. See *supra* notes 251-54 and accompanying text (discussing ability of regulators to govern derivatives use through bank capital adequacy guidelines).

456. See *supra* notes 446-55 and accompanying text (discussing derivatives guidelines and capital adequacy requirements).

457. See, e.g., Saul Hansell, *Bankers Trust and U.S. Set Pact On Disclosure of Derivatives' Risk*, N.Y. TIMES, Dec. 6, 1994, at A1 (noting Bankers Trust agreement to disclose derivatives risk after Federal Reserve Board investigation revealed fraudulent transactions); see also Dominic Bencivenga, *Congressional Agenda; Litigation Reform, Derivative Regulation on Tap*, N.Y. L.J., Jan. 19, 1995, at 5 (discussing terms of Bankers Trust penalty).

458. Hansell, *supra* note 457, at A1.

459. *Id.* at A1. Written agreements are the Federal Reserve's second strictest form of action and are rarely applied to the nation's larger banks. *Id.* The FRB's penalty is particularly significant because it indicates a willingness by the FRB to take strong action against derivatives related fraud, and more importantly, an active position in derivatives regulation. *Id.* Representative Leach responded to the FRB's actions by stating, "[w]hat's been established is a new standard for industry practices that by contract applies to Bankers Trust, but, in effect, could well apply to all banks and potentially all market participants." *Id.* Under the signed agreement, Bankers Trust must now inform its customers of the value of their derivatives positions every day, rather than only upon a customer's request. *Id.*

460. *Id.* This penalty followed in the wake of a private settlement with Gibson Greeting in which BT Securities paid Gibson US\$14 million. Bencivenga, *supra* note 457, at 5. Bankers Trust also agreed without admitting any wrongdoing to payment of a US\$10 million fine jointly to the SEC and CFTC for settlement of additional fraud charges. Saul Hansell, *Settlement By Bankers Trust Unit*, N.Y. TIMES, Dec. 23, 1994, at D1; John C. Coffee Jr., *Bankers Trust Settlement: Whither the Swaps Market*, N.Y. L.J., Jan. 26, 1995, at 5.

b. The Commodities Futures Trading Commission's Derivatives Activity

Unlike more recent derivatives related actions of the FRB and the OCC,⁴⁶¹ the Commodities Futures Trading Commission⁴⁶² ("CFTC") began taking action concerning derivatives as early as 1987.⁴⁶³ The first CFTC actions were in the form of investigatory and enforcement proceedings against the developers of swap transactions involving commodities.⁴⁶⁴ These investigatory and enforcement proceedings ceased upon adoption of an exemption for swaps from most provisions of the Commodities Exchange Act in 1992.⁴⁶⁵ Despite the swap exemption, the CFTC has continued to keep watch over derivative instruments within its jurisdiction.⁴⁶⁶ For instance, the CFTC joint statement of cooperation with the SEC and SIB⁴⁶⁷ promises substantial CFTC involvement in the transnational derivatives market regulatory effort.⁴⁶⁸

c. SEC Action

In July 1992, the SEC adopted new rules that require regulated broker-dealers⁴⁶⁹ to disclose a variety of information re-

461. *See supra* notes 446-60 and accompanying text (discussing OCC and FRB response to derivatives challenges).

462. *See supra* notes 211-14 (discussing origin and purpose of CFTC).

463. Cunningham, *supra* note 19, at 164.

464. *Id.* The result of the CFTC investigations and actions was to completely halt development of the commodity price swap market in United States. *Id.* U.S. institutions in response, shifted their business to alternate markets around the globe. *Id.*

465. *See* Cunningham, *supra* note 19, at 164-67 (discussing derivatives-related actions of CFTC). In order qualify for exempt status, the swap transaction must still meet several requirements. *See supra* note 230 (listing swap exemption requirements).

466. *Statement of Mary L. Schapiro Chairman, Commodity Futures Trading Commission Before the Senate Committee On Banking, Housing and Urban Affairs*, Federal News Service, Jan. 5, 1995, at 24-25. The CFTC has also completed a study reviewing the need, if any, for additional regulation of OTC markets. COMMODITY FUTURES TRADING COMMISSION: OTC DERIVATIVE MARKETS AND THEIR REGULATION (1993). The study concluded that greater coordination between federal regulators in overseeing derivatives markets would be beneficial but no fundamental structural changes in the regulatory system are necessary. *Id.* at 172.

467. Joint Statement, *supra* note 319.

468. *Id.*

469. 17 C.F.R. § 240.17h-1T-2T (1994). Rule 17h-1T establishes a Material Associated Person category. *Id.* Whether a person fits in this category depends on: the closeness of the person's legal relationship with the dealer; the financial requirements of the dealer and the degree to which the two parties are financially independent on one another; the degree to which the two parties are interconnected for operation support;

garding the financial condition of the broker-dealers's materially associated persons.⁴⁷⁰ Such information must be disclosed on a quarterly and annual basis.⁴⁷¹ The SEC promulgated the new rules in response to concern that unregulated associates of the broker-dealers, specifically those associates dealing in derivatives,⁴⁷² could negatively impact the broker-dealers.⁴⁷³

In addition to collecting more information concerning unregulated associates of broker-dealers, the SEC has been working directly with the largest private derivatives traders to develop industry wide guidelines for derivatives use.⁴⁷⁴ While the SEC admits that developing such guidelines will take time, it seeks to preclude legislation by filling regulatory gaps in rules governing derivatives dealers.⁴⁷⁵ Armed with better information regarding the practices and policies of derivatives players, new guidelines, and reporting requirements, the SEC is confident it can prevent future derivatives related problems.⁴⁷⁶ The SEC has also re-

the level of risk present in the associated person's investment activities; and the extent to which the associated person may withdraw capital from the dealer. *Id.*

470. *Id.*; see Final Temporary Risk Assessment Rules, Exchange Act Release No. 34-30,929, 51 S.E.C. Docket 1613, 1992 WL 172844 (explaining risk assessment rules and discussing subsequent public comments). The Rules require that broker-dealers provide to the SEC information regarding associated person. *Id.* The information is to describe material legal proceedings, aggregate amounts of interest rate swaps, and consolidated financial sheets. *Id.*; see Cunningham, *supra* note 19, at 163 (describing rule requirements).

471. 17 C.F.R. § 240.17h-1T-2T.

472. Cunningham, *supra* note 19, at 162.

473. *Id.* at 162-63. The bankruptcy of Drexel Burnham Lambert Group and its subsidiary Drexel Burnham Lambert Inc. spurred the SEC in its efforts to ensure financial stability of broker-dealers. *Id.*

474. Peltz, *supra* note 12, at 65. The SEC has been working with representatives from CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley & Co., and Salomon Brothers to broaden SEC authority without legislation. *Id.* The work group is focusing on four specific areas: management and control, capital requirements, regulatory reporting and disclosure, and sales practices. *Id.* The six derivatives dealers which account for more than 90% of derivatives business in the United States have, as a result of the SEC's efforts, voluntarily agreed to submit their operations to review by federal regulatory agencies. Saul Hansell, *Firms Agree to U.S. Review Of Derivatives Operations*, N.Y. TIMES, Mar. 10, 1995, at D1, D4. The firms specifically agreed to enact internal controls to reduce risk, issue reports of their derivatives activity to the SEC and CFTC, develop computer simulation models to predict derivatives-related risks, and to adopt standards regarding disclosure to clients. *Id.* at D4.

475. Zaitzeff, *supra* note 8, at B9.

476. Lynn Stevens Hume, *Federal Regulators Say They Can Oversee Derivatives and Concerns Are Overstated*, BOND BUYER, Oct. 28, 1993, at 1. J. Carter Beese, a commissioner with the SEC stated, "[o]ur challenge going forward is to coordinate our efforts so that we have an adequate understanding of the aggregate size of the market and properly

sponded to calls from Congress to step up examination of rules governing derivatives use by mutual funds.⁴⁷⁷ After several substantial derivatives-related mutual fund losses,⁴⁷⁸ the SEC responded by issuing a strong warning to the mutual-fund industry.⁴⁷⁹ The SEC urged mutual-funds to take appropriate steps to ensure proper understanding and management of derivatives-related risks.⁴⁸⁰ The SEC subsequently responded with a three-point plan of action⁴⁸¹ designed to improve disclosure rather than adding new regulations or prohibitions.⁴⁸²

d. The Response of Industry Organizations: ISDA and FASB Action

Private organizations such as the Financial Accounting Standards Board⁴⁸³ ("FASB") and the International Swaps and Derivatives Association⁴⁸⁴ ("ISDA") have also played a role in changing the way derivatives users conduct business.⁴⁸⁵ The FASB has promulgated new sets of accounting rules specifically to keep track of financial information arising from derivatives move-

identify" potential risks. *Id.*; see Peltz, *supra* note 12, at 65 (noting that regulators have been trying to convince Congress that they do not need or want more authority to regulate derivatives).

477. Brett D. Fromson, *Legislators Urge SEC Probe of Funds; Derivatives Deals*, WASH. POST, June 16, 1994, at B13. Representatives Edward J. Markey [D-Mass.] and Jack Fields [R-Texas] drafted a letter to the SEC requiring examination of mutual fund rules in response to derivatives-related mutual fund losses. *Id.*

478. *Id.* Recent mutual fund losses by Piper Jaffray Co., PaineWebber Group, and BankAmerica Corp alone totaled in excess of US\$85 million. *Id.*

479. Mark H. Anderson, *SEC Chief Levitt Warns Mutual Funds To Be Cautious in Handling Derivatives*, WALL. ST. J., June 21, 1994, at C18.

480. *Id.*

481. *SEC's Levitt Lays Out Plan for Derivative Holdings*, INVESTMENT DEALERS' DIG., Oct. 3, 1994 at 1. The plan first promised a proposal for a new quantitative risk measure to be added to fund prospectuses. *Id.* The measure would provide investors with a mode by which to judge and compare risk types between different mutual funds. *Id.* The second step would be a new SEC guideline permitting non-money market funds to reduce their holdings of illiquid assets to 10%, from 15% of total assets. *Id.* Finally, the plan included issuing a release seeking public comment on appropriate regulatory and legislative solutions regarding leverage resulting from fund use of derivatives. *Id.*

482. *Id.*

483. See *supra* note 188 (discussing Financial Accounting Standards Board).

484. See *supra* note 189 (discussing International Swaps and Derivatives Association).

485. See Dominic Bencivenga, *Congressional Agenda; Litigation Reform, Derivative Regulation on Tap*, N.Y. L.J., Jan. 19, 1995 at 5 (noting that private regulators like FASB have taken steps to improve disclosure and accounting of derivatives, and acknowledging difficulty of establishing uniform standards).

ments.⁴⁸⁶ Although commentators observe that the FASB derivatives rules have been conservative so far, FASB promises to take continuing account of new information and adopt changes when necessary.⁴⁸⁷ The ISDA has developed the standardized documentation and procedures now used almost universally in derivatives markets.⁴⁸⁸ Because of the work the ISDA has completed, derivatives users face greater legal certainty with respect to the enforceability of their transactions.⁴⁸⁹ The decreased opportunity for counterparty default arising from unenforceability has resulted both in lower legal and credit risks for derivatives users.⁴⁹⁰

C. Transnational Cooperation

Both government regulators and private industry representatives have been able to cooperate separately, and together, on a transnational level.⁴⁹¹ Non-U.S. approaches to derivatives regulation, emphasizing better management control and understanding of derivatives-related risks, have been much more popular than proposed government legislation.⁴⁹² The Bank for Interna-

486. See *supra* notes 281-89 and accompanying text (discussing new FASB treatment of derivatives).

487. *Waiting for FASB's ACT II: Swaps Disclosure Rules Likely To Get Tougher*, AM. BANKER, Oct. 17, 1994.

488. Jill Treanor, *ISDA Aims To Clear Mist Obscuring Derivatives*, Reuters Newswire, Aug. 9, 1994, available in Westlaw INT-NEWS Database; see *supra* notes 290-301 and accompanying text (discussing ISDA master agreements).

489. See *supra* notes 290-301 and accompanying text (discussing ISDA's work and consequences).

490. See *supra* note 301 and accompanying text (noting decreased risks resulting from ISDA master agreements).

491. See, e.g., Joint Statement, *supra* note 319 (discussing cooperation between the SEC, CFTC, and SIB); Joint Press Statement by Basle Committee and IOSCO Technical Committee (July 27, 1994) (discussing cooperation between transnational securities and transnational banking organizations).

492. Steven Burrell, *Derivatives - Regulation v. Risk*, AUSTRALIAN FIN'L REV., Feb. 24, 1993, at 12. Australian financial market regulators believe that sufficient mechanisms are already in place to manage potential derivatives risks. *Id.*; see *Canadian Regulators Take Softer Line On Derivatives*, Reuter Newswire - Canada, May 20, 1994, available in Westlaw, INT-NEWS Database. Richard Gresser, a senior policy analyst at Canada's Superintendent of Financial Institutions, stated that "in the absence of evidence of a [derivatives] problem, I don't think it's time for someone to say the sky is falling." *Id.* Canadian regulators favor as much self-regulation as possible in the derivatives industry. *Id.* German Banking Supervisory Office President Wolfgang Artopoulos has stressed principles of orderly management and thorough credit risk assessment, while rejecting the idea that non-banks doing business in derivatives should be placed under regulatory supervision. *German Bank Regulator Studies Derivative Use - Paper*, Reuter Newswire - West-

tional Settlements⁴⁹³ ("BIS"), through its Basle Committee on Banking Supervision ("Basle Committee"),⁴⁹⁴ and the International Organization of Securities Commissions⁴⁹⁵ ("IOSCO"),

ern Europe, Aug. 24, 1994, available in Westlaw, INT-NEWS Database. Commenting on regulatory proposals, Laura Cha, Executive Director of the Honk Kong Securities and Futures Commission ("SFC") stated that the SFC does not "want to regulate too much because [derivatives] are for sophisticated investors." Kerry Wong, *Commission Studies Views on Derivative*, SOUTH CHINA MORNING POST, Oct. 2, 1994, at 1. The chairman of the SFC stated that the commission would wait for international coordination before amending over-the-counter derivatives rules. *HK SFC Plans No Immediate OTC Derivatives Changes*, Reuter Newswire - Far East, June, 8, 1994, available in Westlaw, INT-NEWS Database. Japanese regulators, in response to the Barings Bank failure, declined to intensify regulatory efforts and instead called for increased internal risk management and disclosure. *Japan Derivatives Allergy Seen Boosted By Barings*, Reuter Newswire - Far East, Feb. 27, 1995, available in Westlaw, INT-NEWS Database. Tokyo Stock Exchange head Yoshiaki Kaneko noted that "some people in Japan are afraid that the Japanese market might be defective as an international market and that its role might be declining because of high cost and excessive regulation." Anthony Rowley, *Tokyo, London Exchange Chiefs Clash Over Securities Laws*, BUS. TIMES (Japan), Oct. 21, 1994, at 1. Onno Ruding, Vice Chairman of Citicorp and former Dutch Finance Minister, stated "I welcome the active role of regulators, but it is not wise to bring in new additional legislation. There are sufficient powers in the current laws . . ." *No Need For New Derivative Laws - Ruding*, Reuter Newswire - Western Europe, Sept. 9, 1994, available in, Westlaw, INT-NEWS Database. Singapore's Finance Minister Richard Hu recognized that crippling derivatives losses have occurred when users fail to appreciate or manage derivatives risk. Quak Hiang Whai, *Derivatives Here To Stay Despite Concern Over Losses Abroad - Dr Hu*, BUS. TIMES (Singapore), Jan. 10, 1995, at 1. Dr. Hu places responsibility for such losses on the financial institutions. *Id.*

493. See GAO Report, *supra* note 2, at 32 (describing origins and functions of Bank for International Settlements). Western European Central banks established the Bank for International Settlements in 1930 in Basle, Switzerland. *Id.* One of the bank's primary functions is to provide a forum for cooperative efforts by central banks from the world's industrial countries. *Id.*

494. See J.J. NORTON ET AL., INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990s 265 (1994). The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities. *Id.* The Committee, formed by central bank governors of the Group of Ten Countries in 1975 was formed in response to the failure of Bankhaus Herstatt of West Germany. *Id.* The Basle Committee's primary aim is to promote gradual transnational convergence of supervisory practices governing financial institutions. JOSEPH J. NORTON, BANK REGULATION AND SUPERVISION IN THE 90s 83 (1991). The Basle Committee operates under the administrative auspices of the Bank for International Settlements and meets regularly three or four times a year. *Id.* The Committee, currently chaired by Dott T. Padoa-Schippa, Deputy Director General of the Bank of Italy, represents central banks and other authorities possessing prudential supervision responsibilities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, United States, and the Secretariat. *Id.*; see International Monetary Fund: Group of Ten Report on the Functioning of the Monetary System, May 16, 1985, 24 I.L.M. 1685 (describing the origins and development of Group of 10).

495. HAROLD S. BLOOMENTHAL, INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 1.10(2)(a), at 25 (1982). The International Organization of Securities

have issued guidelines derivatives users should employ in dealing with derivatives-related risks.⁴⁹⁶ In partial recognition of IOSCO's work,⁴⁹⁷ the SEC and CFTC have joined with the U.K.'s Securities and Investments Board⁴⁹⁸ ("SIB"), in issuing a statement of cooperation in developing a transnational regulatory approach to govern derivatives.⁴⁹⁹

Commissions was formed in 1974 to provide a forum for securities regulators from different countries to promote transnational cooperation in the development of securities laws. *Id.* The IOSCO currently consists of over 100 members from greater than sixty different countries. See *Securities Regulators to Begin 6-day Meeting Sunday*, JAPAN WEEKLY MONITOR, Oct. 17, 1994, available in Westlaw, PTS-NEWS Database (noting that 800 officials from 110 regulatory bodies from 64 countries and two regions were expected to gather in Tokyo for IOSCO meetings in October of 1994). IOSCO's Technical and Market Development Committees attempt to identify and solve areas of transnational regulatory conflict. BLOOMENTHAL, *supra* note 495, § 1.10(2)(b), at 26. Although IOSCO lacks binding authority over its members, it is expected to contribute to transnational coordination of securities markets during the 1990s and beyond. *Id.* § 1.10(2)(a), at 25.

496. TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, OPERATIONAL AND FINANCIAL RISK MANAGEMENT CONTROL MECHANISMS FOR OVER-THE-COUNTER DERIVATIVES ACTIVITIES OF REGULATED SECURITIES FIRMS 1 (1994) [hereinafter IOSCO GUIDELINES]. Albert Cheok, Executive Director of the Hong Kong Monetary Authority described the Basle and Iosco guidelines as a "global, co-ordinated initiative by banking and securities supervisors to promote better risk management of financial derivative activities." Noel Fung, *Talks Begin On Management of Derivatives Risk*, SOUTH CHINA MORNING POST, Aug. 2, 1994, at 2; see *Global Derivatives Reporting Rules Proposed - Paper*, Reuter Newswire - Far East, Sept. 19, 1994, available in Westlaw, INT-NEWS Database (describing requirements under separate IOSCO proposal regarding dealer reporting).

497. Joint Statement, *supra* note 319, at 1. The joint statement states that "the Authorities believe the work in progress in the International Organization of Securities Commissions regarding the regulation of OTC derivatives is valuable, and intend to continue working within that framework." *Id.*

498. See 3 THE NEW PALGRAVE DICTIONARY OF MONEY & FINANCE 424 (1992) (discussing purpose, function and authority of Securities and Investment Board). Like the SEC, the SIB has broad powers to both shape the regulatory system and to enforce applicable rules. *Id.* at 425. Formed in 1985, the SIB, unlike the SEC, is a private company. The SIB's purpose is to ensure protection of investors while promoting interests of commerce through the establishment and maintenance of high standards in the United Kingdom's financial services industry. *Id.* at 424. Its activities are aimed principally at the development and administration of a regulation system for entities involved in the investment business. *Id.*

499. Joint Statement *supra* note 319. The International Organization of Accountants has also made transnational progress on the issue of financial reporting of derivatives. *IASC Nears Guidelines For Derivatives Trade*, Financial Dagblad, Oct. 26, 1994, available in Westlaw, INT-NEWS Database.

1. The Basle Committee and IOSCO Derivatives Guidelines

The Basle Committee⁵⁰⁰ and IOSCO⁵⁰¹ have formulated derivatives guidelines together to help harmonize derivatives practices across borders and industries.⁵⁰² Both sets of guidelines directly address issues of market, credit, operational, legal, and liquidity risks.⁵⁰³ As applied to financial institutions, the guidelines additionally establish recommended written policies and procedures outlining management guidance that the board of directors must approve.⁵⁰⁴ Most importantly, measuring, monitoring, and controlling of risk should take place independently from individuals actively engaged in derivatives trading

500. See *supra* note 494 (discussing Basle Committee).

501. See *supra* note 495 (discussing International Organization of Securities Commissions).

502. BASLE COMMITTEE ON BANKING SUPERVISION, RISK MANAGEMENT GUIDELINES FOR DERIVATIVES 1 (July 1994) [hereinafter *BASLE GUIDELINES*]; IOSCO GUIDELINES, *supra* note 496. Guillermo Harteneck, chairman of IOSCO's Emerging Markets Committee, stated "[d]eveloped markets' problems are essentially international — the harmonization of principles to make international business more fluid and to exchange information with other regulatory agencies." *Emerging Markets Watch Dogs Said To Have Own Agenda*, Reuter Newswire - Far East, Oct. 21, 1994, available in Westlaw, INT-NEWS Database. Both organizations worked together because as Tim Shephard-Walwyn, chairman of the IOSCO technical Committee working group stated, "[c]learly it is not possible for securities regulators to progress this subject (of reporting to regulators) on our own because many participants are banks." *Securities Watchdogs, Basle to Work on Derivatives*, Reuter Newswire - Far East, Oct. 21, 1994, available in Westlaw, INT-NEWS Database.

503. *BASLE GUIDELINES*, *supra* note 502, at 13-19; *IOSCO GUIDELINES*, *supra* note 496, at 3-4. The guidelines call for independent management and calculation of market risk and monitoring of the effectiveness of pricing and valuation systems. *BASLE GUIDELINES*, *supra* note 502, at 6; *IOSCO GUIDELINES*, *supra* note 496, at 10. Proper risk controls should also implement independent credit risk management calculated across all customers and products. *BASLE GUIDELINES*, *supra* note 502, at 13-14; *IOSCO GUIDELINES*, *supra* note 496, at 11. With regard to operational risks, the guidelines suggest that firms ensure the availability of proper resources to support operations and systems development and maintenance. *BASLE GUIDELINES*, *supra* note 502, at 16; *IOSCO GUIDELINES*, *supra* note 496, at 11. The guidelines recommend that, to lower legal risk, firms should utilize netting and master agreements, as well as thorough credit history research before entering into any transaction. *BASLE GUIDELINES*, *supra* note 502, at 13; *IOSCO GUIDELINES*, *supra* note 496, at 11-12. Furthermore, in lowering liquidity risk, firms should be aware of the size, depth and liquidity of particular derivatives markets. *BASLE GUIDELINES*, *supra* note 502, at 15; *IOSCO GUIDELINES*, *supra* note 496, at 14.

504. *BASLE GUIDELINES*, *supra* note 502, at 5; *IOSCO GUIDELINES*, *supra* note 496, at 9; see *Details of Basle IOSCO Derivatives Guidelines*, Reuter Newswire - United Kingdom, July 26, 1994, available in Westlaw, INT-NEWS Database (discussing risk managing provision of Basle and IOSCO derivatives guidelines).

activities.⁵⁰⁵ In taking this approach, the guidelines focus on the need for sound internal risk management as opposed to external regulation.⁵⁰⁶ Although the Basle Committee and IOSCO do not have the power to bind derivatives users to the guidelines, non-U.S. regulators have positively responded to the internal risk management.⁵⁰⁷

2. The Joint SEC, CFTC, SIB Statement of Cooperation

Resulting from years of discussions between three influential regulators, the SEC, CFTC, and SIB agreement sets forth a joint-agency agenda to address derivatives related concerns.⁵⁰⁸ The promised agenda seeks to establish substantial cooperation between the three agencies in establishing a transnational regulatory framework to reduce derivatives-related risk.⁵⁰⁹ The agreement has been described as the first of its kind.⁵¹⁰

The agenda prescribed by the joint statement consists of a

505. BASLE GUIDELINES, *supra* note 502, at 6; IOSCO GUIDELINES, *supra* note 496, at 11-12.

506. *World Watchdogs Grapple With Derivative Disclosure*, Reuter Newswire - Far East, Oct. 18, 1994, available in Westlaw, INT-NEWS Database.

507. *HK Issues Basle IOSCO Guidelines For Consultation*, Reuter Newswire - Far East, Aug. 1, 1994, available in Westlaw, INT-NEWS Database. The Monetary Authority of Hong Kong, Hong Kong's central bank, issued the Basle and IOSCO guidelines for industry comment before deciding how many of the guidelines should form the basis for Hong Kong's forthcoming formal derivatives guidelines. *Id.* In response to the failure of Barings Bank, a Japanese monetary source in Tokyo responded that the appropriate response would be to continue moving in the direction of internal risk management as taken by the Basle Committee and IOSCO. *Japan Derivatives Allergy Seen Boosted By Barings*, Reuter Newswire - Far East, Feb. 27, 1995, available in Westlaw, INT-NEWS Database. The International Swaps and Derivatives Association although recognizing slight disagreements between its approach and the Basle/IOSCO approach stated that it "is looking forward to an ongoing dialogue with the BIS on all these issues." *ISDA Seeks Changes To BIS Derivatives Proposals*, Reuter Newswire - USA, Jan. 7, 1994, available in Westlaw, INT-NEWS Database.

508. Joint Statement, *supra* note 319. SEC commissioner Arthur Levitt noted that by working cooperatively, the SEC "can create a springboard for the development of sound, cross-border regulatory schemes for OTC derivatives." *SEC, CFTC, and U.K. Regulators Issue Statement on OTC Derivatives*, 62 Banking Rep. (BNA) No. 12, at 561 (March 21, 1994). Andrew Large, the SIB's chairman described the statement's meaning, that the securities regulators are now "singing from the same hymn sheet." *Id.*

509. Joint Statement, *supra* note 319, at 1.

510. *SEC, CFTC, and U.K. Regulators Issue Statement on OTC Derivatives*, 62 Banking Rep. (BNA) No. 12, at 561 (Mar. 21, 1994). The CFTC described the joint statement as "the first international understanding among futures and securities regulators for developing and coordinating an approach to the OTC derivatives market." *Id.*

seven-point program of action.⁵¹¹ First, the regulators have agreed that in the interests of promoting transnational oversight, they will enhance existing arrangements for sharing information.⁵¹² Second, the regulators have agreed to improve risk management by promoting the use of legally enforceable netting.⁵¹³ Third, in order to address concerns regarding excess leverage in derivatives markets, the agencies will promote the estab-

511. Joint Statement, *supra* note 319, at 1.

512. *Id.* at I. The authorities plan specifically to exchange financial and operational information concerning major securities firms that operate across the agencies's jurisdictional boundaries. *Id.* Such a transfer of information is to occur upon either one of two events if the information concerns a firm subject to SEC jurisdiction. *Id.* at 1. The first would be the occurrence of an event that would serve to put one of the authorities on warning that the subject firm was having "significant" financial or operational difficulties. *Id.* The statement notes that with regard to a securities firm, such an event would be when 1) a securities firm under Rule 17a-11 of the Securities Exchange Act of 1934 must give notice to its U.S. self regulatory organization because i) its minimum net capital falls below the minimum required by SEC net capital rules; ii) its books and records are no longer current; or iii) the internal controls or accounting safeguards are found to be inadequate. *Id.* The second possible triggering event would be a securities firm's notification pursuant to Section 5(a)(1) of the Securities Investor Protection Act of 1970 that the firm is in or is approaching financial difficulty or is about to materially default whether on an exchange or OTC transaction. *Id.*

If the firm is subject to Commodities Exchange Act requirements, the event would occur under either of three other possibilities. *Id.* First, the event would trigger if the firm pursuant to Rule 1.12 of the CEA, 7 U.S.C. § 4 (1988 & Supp. V 1993), provides notice to its self-regulatory agency or the CFTC that a) the firm's adjusted net capital has fallen below the applicable net capital rule, b) the firm's books and records are not current, or c) the firm has not satisfied accounting system, internal accounting controls or customer safeguarding procedures as specified in Rule 1.16(d)(1) under the CEA. *Id.* The second event would be filing of notification with the CFTC under Rule 190.6 of a bankruptcy filing or third, other notification by the firm to the appropriate regulator of information negatively affecting its financial or operational validity. *Id.*

In the United Kingdom a triggering event would occur when a regulator has reason to believe that a firm under its jurisdiction 1) is or will be in breach of financial reserve requirements, 2) will or expects to be unable to submit proper financial reporting statements at the appropriate time, 3) is about to default on an OTC or exchange transaction, or 4) is, or expects to be unable to maintain adequate accounting systems or internal controls.

The second trigger of information sharing would simply occur upon request by one of the regulatory authorities. *Id.* Such a request need only be based upon reasonable grounds for concern that the financial or operating condition of the firm may be materially affected by a related entity. *Id.*

The joint statement also describes the type of information the Authorities will provide. *Id.* They will provide information regarding financial and operational conditions including net and gross capital, capital requirements, financial reports filed with the applicable Authority and any other such information as the Authorities deem appropriate. *Id.*

513. *Id.* at II. The Authorities stress the benefits of appropriately designed netting agreements and agree that future capital standards should take these types of agree-

lishment of prudent risk-based capital charges and the use by firms of stress simulations of severe market conditions.⁵¹⁴ Fourth, the agencies will work together to promote the development and use of sound management controls.⁵¹⁵ Fifth, in recognition of the complexity and lack of transparency characteristic of many derivatives products, the agencies agree to encourage tougher standards for customer protection.⁵¹⁶ Sixth, the agencies recognize the importance of clearinghouses in reducing credit risk and as such, they agree to examine the regulatory framework for multilateral clearing arrangements.⁵¹⁷ Finally, be-

ments into account. *Id.*; see *supra* note 150 (discussing netting agreements and their benefits).

514. Joint Statement *supra* note 319, at III. The Authorities state that capital standards should pay particular attention to market and counterparty risks. *Id.* In this risk context the regulators plan to encourage incentives for good risk management. For example, a firm that uses legally enforceable netting agreements and/or other appropriate risk management techniques might be subject to lower capital requirements. *Id.* The Authorities also agree, for prudential reasons, to encourage market stress simulations by derivatives users. *Id.*

515. *Id.* at IV. In encouraging effective management controls, the Joint Statement states, "management controls are critical for a securities and futures firm because they provide the firm with the ability to monitor and control activities and risk. This is particularly important in the field of OTC derivatives because of the complexity, and rate of change, of the OTC products being developed." *Id.* The Authorities then draw on seven concepts to provide guidance in developing appropriate management controls. *Id.* The policies recommend that a firm's board of directors should promulgate and oversee derivatives activity policies. *Id.* Execution of these policies should reflect proper valuation of risks. *Id.* Management policies should clearly delineate responsibility throughout the transaction chain. *Id.* Information systems should be designed and function to provide adequate information about not only about the derivatives in a particular transaction but also, other factors relevant to the transaction. *Id.* Appropriate expertise at all levels and internal controls independent from other firm personnel should be dedicated to evaluation of credit, market and legal risk. *Id.* Finally, the policies should take advantage of available risk reducing techniques. *Id.*

516. *Id.* at V. In addressing the issue of customer protection, the joint statement proclaims that the Authorities will review current transaction requirements and recommend amendments where necessary to reflect the nature of the derivatives industry. *Id.* The Authorities also agree to promote customer protection by encourage the customer himself to develop and maintain adequate management controls to address the risks inherent in their transactions. *Id.*

517. *Id.* at VI. The Authorities generally recognize the benefits of clearinghouse type arrangements and agree to promote similar arrangements in OTC derivatives markets. *Id.* One of the benefits that clearinghouses provide is the promotion of confidence in markets resulting from clearinghouse responsibility for counterparty defaults. *Id.* According to the statement, clearinghouses also facilitate customer matching, registration, record of execution, and designation of trades. *Id.* The three Authorities propose to work with other industry groups and participants to consider possible adoptions of clearinghouse-type arrangements to the OTC market. *Id.*

cause the agencies consider development of accounting recognition to be of great importance, they have agreed to promote improved standards for accounting recognition, measurement, and disclosure.⁵¹⁸

III. *DERIVATIVES LEGISLATION IS UNNECESSARY IN LIGHT OF CURRENT REGULATORY EFFORTS*

Passing new legislation in the United States, in accordance with the wishes of some current members of Congress⁵¹⁹ is not the best solution to derivatives-related problems. After comprehending the actual level of risk global derivatives markets present,⁵²⁰ it is readily apparent that the best solution in addressing derivatives-related challenges exists on a transnational scale, rather than narrowly in the United States. Further development of the agenda set forth by the SEC, CFTC, SIB, IOSCO, and the Basle Committee,⁵²¹ will prove to be the most prudent regulatory approach to derivatives.

A. *Actual Derivatives-Related Risk Is Lower Than Some Commentators Have Indicated*

Before choosing a specific plan of action to regulate derivatives, Congress must understand that the actual nature of derivatives-related risk is much lower than anxious legislators have described. Although the size of global derivatives markets may be as large as US\$35 trillion,⁵²² only a fraction of those dollars are actually at risk.⁵²³ Derivatives are not financial instruments that

518. *Id.* at VII. With regard to advancing accounting and disclosure, the Authorities are particularly interested in promoting standards that will result in greater market transparency and adequate information to end-users. *Id.* The Authorities agree to work with and to encourage appropriate accounting standards setters to achieve this result. *Id.*

519. See *supra* notes 328-421 and accompanying text (discussing proposed derivatives-governing legislation).

520. See GROUP OF THIRTY, *supra* note 17, at 53-54 (discussing methods of calculating size and risk of global derivatives markets).

521. See *supra* notes 491-507 (discussing derivatives-related actions of SEC, CFTC, SIB, IOSCO, and Basle Committee).

522. See *supra* note 2 (discussing estimates of derivatives market size).

523. GROUP OF THIRTY, *supra* note 17, at 53-54. Measurements of the size and risk of derivatives markets that count total derivatives activity do not accurately forecast risk for three reasons. *Id.* at 54. Measuring the total value of all derivatives contracts fails to take into account that many of these contracts, in the hands of end-users, offset one another. *Id.* One party may possess two offsetting derivatives contracts, and thus, the

necessarily carry a lot of risk.⁵²⁴ Even the General Accounting Office report on derivatives, one of the few sources recommending derivatives legislation, cannot provide any evidence of impending market failure as a result of derivatives.⁵²⁵

B. Faulty Derivative Financial Instruments Have Not Been the Fundamental Cause of Derivatives Losses

Most derivatives-related losses, are attributable not to the derivative instrument itself, but instead to poor financial planning.⁵²⁶ Commentators widely accept, for example, that derivatives did not send Orange County, California into bankruptcy, but rather, risky financial planning by the county treasurer was the source of the county's difficulties.⁵²⁷ Derivatives investors must realize that some derivatives, are naturally risky instruments⁵²⁸ and thus, a one-sided investment in a risky derivative, without an offsetting hedge investment,⁵²⁹ is likely to either gain, or lose value rapidly. Derivatives investors concerned with the prospect of large losses would be wise to cover their position by hedging,⁵³⁰ or avoid derivatives entirely.

net risk held by the party is zero, and not the total amount of risk of each contract added together. *Id.* Second, simply measuring the market by total activity does not account for risks created by varying maturities of the derivatives contracts. *Id.* Contracts with different maturities carry different risks, and therefore, a true measure of market size and risk must also examine the maturities of each contract. *Id.* Finally, different types of derivatives have different risk profiles. *Id.* Market size calculations must subsequently account for the nature of particular derivatives instruments. *Id.*

524. See Waldman, *supra* note 2, at 1032 (estimating only US\$170 billion to be at risk in a US\$7 billion derivatives market).

525. Zaitzeff, *supra* note 8, at B9.

526. See *supra* notes 302-13 and accompanying text (discussing derivatives losses and causes).

527. Tony Munroe, *Fed Chief Urges Senate Not to Make 'Mistake' of Regulating Derivatives*, WASH. TIMES, Jan. 6, 1995, at B7. Orange County's financial planners made large leveraged bets on interest rates and lost. Mark Platte, *O.C. To Liquidate Its Portfolio*, L.A. TIMES, Dec. 14, 1994, at A1.

528. See *supra* notes 119-84 and accompanying text (discussing derivative inherent risks).

529. See *supra* notes 94-109 and accompanying text (discussing derivatives and hedging).

530. See *supra* notes 93-118 and accompanying text (discussing aspects of hedging and speculation).

C. *Current Regulators Are Qualified to Address Derivatives-Related Challenges Without Congressional Assistance*

Accepting that somebody must take responsibility for keeping a regulatory watch on derivatives markets, current regulatory agencies, not distant legislators in Washington, are better suited for the challenge. By imposing untested legislation upon derivatives markets, Congress runs the risk of hampering, if not completely disrupting the efforts of those entities that are developing solutions to derivatives problems.⁵³¹ Any approach by Congress other than to let regulators regulate, would risk worsening current derivatives-related risks.

Regulators and private industry representatives have proved their willingness to carefully and methodically address derivatives-related problems with respect to derivatives dealers.⁵³² These efforts have been able to achieve material results. The SEC's cooperation with six large derivatives firms, for example, culminated in an agreement whereby those firms would be subject to SEC and CFTC oversight.⁵³³ Proposed legislation also neglects to acknowledge the SEC's dealer regulating powers conveyed by the SEC's Final Temporary Risk Assessment rules.⁵³⁴ The rules provide the SEC with much of the information and regulatory oversight that House bill 4745 seeks to grant.⁵³⁵ The SEC has also promulgated specific rules to provide itself with information necessary to efficiently oversee the activities of broker-dealers and their associated persons.⁵³⁶ Passing legislation that would impose new rules, or grant current SEC authority to an-

531. *See supra* notes 438-518 and accompanying text (discussing past and current regulatory efforts directed towards derivatives).

532. *See supra* notes 438-518 and accompanying text (noting public regulator and private industry organizations responses to derivatives-related problems).

533. *See supra* note 474 and accompanying text (discussing SEC cooperation with CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley & Co., and Salomon Brothers).

534. *See supra* note 470 and accompanying text (discussing Final Temporary Risk Assessment Rules).

535. *See supra* notes 380-82 and accompanying text (discussing House Bill 4745's requirements regarding materially associated persons of brokers and dealers); *see also supra* notes 469-73 and accompanying text (discussing Final Temporary Risk Assessment Rules' requirements with regard to materially associated persons of brokers and dealers).

536. *See supra* notes 469-70 and accompanying text (discussing new SEC disclosure rules).

other agency,⁵³⁷ would only invite less efficient oversight, while interrupting current effective regulatory efforts.

Additionally, between the SEC, CFTC, and SIB joint regulatory efforts,⁵³⁸ and other actions by the FRB and OCC,⁵³⁹ most all of the current concerns of Congress are already being addressed. Congressional proposals appear to be aimed at reducing the risk of market losses by developing sufficient control mechanisms for banks and other end-users.⁵⁴⁰ Yet, the OCC and FRB for example, have already issued mandatory derivatives guidelines that require the same standards and controls that the new congressional legislation proposes.⁵⁴¹ The FRB and OCC also have the power to discourage the more speculative uses of derivatives by banks, simply by assigning risky derivatives a lower value when calculating capital adequacy.⁵⁴² The derivatives guidelines and capital adequacy requirements provide banking regulators two substantial tools with which to control derivatives use by the nation's banks. Further legislatively granted tools are at this point, unnecessary.

Like the OCC and FRB guidelines, the SEC, CFTC, and SIB statement also aims to achieve goals similar to those behind proposed legislation. The joint statement shows for example, that the three agencies recognize the value of capital standards, specifically rewarding lower risk with lower capital requirements.⁵⁴³ Similar to proposed legislation, the three regulatory authorities also plan to require derivatives users to implement management control standards that directly address market, credit, and legal

537. See, e.g., H.R. 20 (seeking to establish Federal Derivatives Commission usurping regulatory control of SEC); see also H.R. 4745 103d Cong. 2d Sess. (1994) (seeking to establish new agency to oversee derivatives dealers).

538. See *supra* notes 508-18 and accompanying text (discussing SEC, CFTC and SIB joint regulatory efforts).

539. See *supra* notes 446-60 and accompanying text (discussing FRB and OCC regulatory efforts).

540. See *supra* notes 338-96, and accompanying text (discussing specific provisions of proposed derivatives-governing bills).

541. See Zaitzeff, *supra* note 8, at B9 (noting that because banking guidelines require banks to develop written derivatives policies and identification of fundamental derivatives risks, they appear to address key safety and soundness objectives of Gonzalez and Leach bills).

542. See *supra* note 254 and accompanying text (discussing FRB and OCC power to discourage speculative derivatives use by changing capital adequacy calculations).

543. See *supra* note 514 (discussing capital adequacy provisions of joint statement).

risks.⁵⁴⁴ The authorities are thus, already in cross-border agreement on the very requirements the Gonzalez and Leach bills plan to impose.⁵⁴⁵ The proposed bills in this respect will not accomplish anything on a single nationality basis that is not already being accomplished transnationally by current market regulators.

D. *Transnational Regulation Is the Optimal Solution*

Congress should also refrain from passing derivatives governing legislation because derivatives present a global challenge that is not an exclusive responsibility of the United States to resolve.⁵⁴⁶ Passing new regulations that will restrict the freedom of derivatives dealers and users in the United States invites the risk of sending U.S. markets to other countries.⁵⁴⁷ Investors in derivatives seek the benefits that derivatives provide.⁵⁴⁸ If that benefit, however, is outweighed by the cost of complying with new legislation, investors will no longer seek those benefits in United States markets. Congress should take careful note of the drying up of Japanese markets after those markets became subject to new regulation.⁵⁴⁹ If Congress chooses to pass legislation that affects only U.S. markets, it will face the risk of substantially limiting a multi-billion dollar profit-making and taxpaying industry,⁵⁵⁰ while offering little protection to the investor who will be

544. See *supra* note 515 (discussing requirements of joint statement that management controls address credit, market and legal risks).

545. See H.R. 20, 104th Cong., 1st Sess. (1995); H.R. 31, 104th Cong., 1st Sess. (1995) (imposing requirements substantially similar to those already imposed by current regulations).

546. See GAO REPORT, *supra* note 2, at 13 (discussing need for coordinated transnational efforts to meet derivatives-related challenges).

547. See Waldman, *supra* note 2, at 1080 (noting that government regulation imposes substantial costs and impediments on users of financial products).

548. See *supra* notes 57-118 and accompanying text (discussing benefits derived from using derivatives).

549. See Anthony Rowley, *Tokyo, London Exchange Chiefs Clash Over Securities Laws*, BUSINESS TIMES - SINGAPORE, October 21, 1994, at 1 (noting Japan's loss of derivatives business due to high cost of excessive regulation). Japan's constrictive regulatory approach to derivatives has moved much of Japan's derivatives business to less restrictive overseas locations. Linda Sieg, *Japan Derivatives Players Bemoan Restrictions*, Reuter Newswire - Far East, October 14, 1994, at 1, available in Westlaw, INT-NEWS Database. Japanese regulators are expected to relax some of their more restrictive requirements in order to win back lost business. *Id.*

550. See Peltz, *supra* note 12, at 65 (noting that uneven transnational regulation will cause business to shift to least regulated markets). Lewis Teel, a high ranking derivatives manager at BankAmerica corp. stated that derivatives markets are "one of the

forced to seek alternatives in markets governed by even less regulation than those currently found in the United States.⁵⁵¹

Furthermore, provisions in Washington's proposed bills that require regulatory authorities to work together on a transnational scale epitomize the bills' lack of substance.⁵⁵² The degree of cooperation existing between subject authorities is commendable as evidenced by the joint statement⁵⁵³ and other mentioned joint efforts.⁵⁵⁴ Advancement in the field of derivatives regulation certainly need not be ordered by a Congress ready to take credit for resolving a nonexistent market crisis.

E. *Congressional Restraint Will Promote Further Understanding and Control of Derivatives-Related Risks*

Congress should be patient with the derivatives industry. Derivative financial instruments are still relatively new⁵⁵⁵ to the financial community and as such, investors will need time to get to know all the benefits and risks presented by derivatives. Significant financial losses incurred by some investors,⁵⁵⁶ are serving as warning signals to other investors contemplating putting their investment money into risky financial instruments. The riskiest derivatives have already seen a decline in popularity,⁵⁵⁷ and many users are currently reevaluating their derivatives positions and policies.⁵⁵⁸

only truly global product markets, which can move at the drop of a pin." *Id.* Federal Reserve Board Governor John Laware stated that if Congress chooses to write a bill to impose restrictions on derivatives, "we'll simply export this market to London or Frankfurt or Tokyo or someplace else." *Fed to Issue Proposal to Address Capital Assessment Needs for Loan Securitization*, 64 *Banking Rep. (BNA)* No. 4, at 150 (Jan. 23, 1995).

551. See Waldman, *supra* note 2, at 1081 (noting that impact of legislation in United States would force transactions to other markets, thus subjecting users to less regulation).

552. See *supra* notes 367-69 and accompanying text (discussing House Bill 20's transnational cooperation provision).

553. Joint Statement, *supra* note 319.

554. See *supra* notes 491-518 and accompanying text (discussing transnational cooperation in addressing derivatives-related issues).

555. See *supra* note 3 (discussing history of derivatives).

556. See *supra* notes 302-13 and accompanying text (discussing derivatives-related losses).

557. See *Beleaguered Giant*, *supra* note 2, at A1 (noting that investors' fear of large derivatives-related losses has stalled business in riskier derivatives). New offerings of the riskiest types of derivatives are virtually non-existent. *Id.*

558. *Id.* Corporate law firms, for example, have sent advisory letters to clients alerting clients to controls they might want to impose on their derivative trading activi-

CONCLUSION

The introduction of derivative financial instruments into world capital markets has provided investors with new opportunities and regulators with evolving challenges. The subject of how to treat these instruments from a regulatory standpoint has attracted the attention of cautious congressmen and professional market regulators. Efforts of existing financial market regulators are addressing, from a transnational perspective, derivatives-related challenges in an orderly and efficient manner. Congress has proposed legislation aimed at eliminating problems that have yet to materialize. These proposals may, at worst, threaten the existing regulatory framework, and, at best, simply add a legislative gloss to current regulation, thus, allowing Congress to take credit for averting a financial disaster that was never to occur. By allowing regulatory agencies to handle financial market challenges without interference, Congress will be able to take credit not only for creating the real problem solvers, but also for resisting the impulse to interfere when interference is unnecessary.

ties. *Id.* Federal Reserve Board Governor noted that derivatives users are now focusing much more closely on fundamental derivatives risks. *Regulators' Progress Will Determine Lawmakers' Actions, Fed's Phillips Says*, Banking Rep. (BNA) No. 4, at 160 (Jan. 23, 1995).