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Cover Page Footnote

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HAVE YOU HEDGED TODAY? THE INEVITABLE ADVENT OF CONSUMER DERIVATIVES

*Carolyn H. Jackson**

> The long history of finance is cluttered with stories of fortunes lost on big bets. No one needed derivatives in order to go broke in a hurry. No one need go broke any faster just because derivatives have become a widely used financial instrument in our times. The instrument is the messenger; the investor is the message.[1]

INTRODUCTION

During your hectic rush-hour drive to work, you contemplate the good news—your daughter has been accepted to the college of her dreams. Simultaneously, you reflect on the down side, namely, the substantial tuition payments are going to dramatically increase your fixed monthly payments. Nagging at the back of your mind are the financial news reports cautioning that interest rates might rise to the double-digit levels of the 1970s and early 1980s due to the current over-heated inflationary economy.

Given the considerable increase in your monthly fixed payments, you realize that your thirty-year variable rate mortgage is just too risky. A fixed rate mortgage would provide you with greater financial certainty and insulate you from any increase in interest rates. Pre-paying your existing mortgage and re-negotiating a new variable rate mortgage, however, could take months, and would inevitably be time consuming and stress inducing.

As you take the exit off the highway that leads to your office, you pass an ATM facility of the bank that provided your mortgage. You recall that at the same time you had signed the mortgage agreement, you signed another agreement with the bank—a swap agreement. You stop at the ATM machine. After entering your card and password, you touch the screen entitled "swap contract." You then select the mortgage screen. It tells you that you could currently convert your variable rate interest payments on your mortgage to a fixed rate of six percent. You punch, "YES." That's it—no bank meetings, no new mortgage agreements, no time delays, no missed market opportunities. In a matter of seconds, your swap agreement has allowed you

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1. Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk 326 (1996).

to alter your mortgage interest payments to a structure that best suits your current financial needs.

The above hypothetical is by no means far-fetched. Over the past two decades, privately negotiated derivatives (swaps) have revolutionized how financial institutions and corporations evaluate, quantify, and manage risk.[2] Access to new funding and investment markets, lower borrowing costs, increased investment yields, and low-cost, flexible asset liability management are among the myriad purported benefits of swaps.[3] Everyone, it seems, is on the derivatives bandwagon. Everyone, that is, except for consumers.

Despite the seemingly endless financial advantages of derivatives, to date only a very limited and sporadic retail derivatives market exists.[4] Some retail participation is direct, such as a consumer entering into a mortgage with a periodic cap.[5] Most retail participation, however, is indirect, such as a consumer investing in a hedge fund that utilizes derivatives to manage the portfolio or in the shares of a corporation that engages in derivatives.[6] Individuals are not utilizing derivatives in managing their financial activities on a daily basis. If derivatives are indeed invaluable as a risk management tool for corporations,[7] they should be equally invaluable for ordinary consumers.

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2. *See* Robert M. McLaughlin, Over-the-Counter Derivative Products: A Guide to Business and Legal Risk Management and Documentation 1 (1998) (commenting on the forces that moved derivatives markets to the "forefront of the world economic scene"); Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers,* 29 Loy. Chi. L.J. 527, 530 (1998) (discussing derivatives, "predominant role in the financial markets"). Derivative transactions fall broadly into three segments: (1) privately negotiated derivatives between two arms-length participants; (2) derivatives traded on an organized exchange, i.e., futures; and (3) derivatives that are embedded in a capital raising security. The scope of this Note is limited to privately negotiated derivatives. For an overview of the segmentation of derivatives transactions into these three broad categories, see Christopher L. Culp Competitive Enter. Inst., A Primer on Derivatives: Their Mechanics, Uses, Risks, and Regulation, 3-30 (1995) [hereinafter Culp, *Primer on Derivatives*]. *See also infra* notes 41-84 and accompanying text (discussing the various derivative products within the three categories).

3. *See* Culp, Primer on Derivatives, *supra* note 2, at 40-42.

4. *See id.* at 81-82 (discussing the absence of "widows and orphans" in what is generally regarded as a wholesale market); Ronald H. Filler, *Two-Tiered Regulation*, Futures Industry, Feb./Mar. 1999, at 1, 21 (stating that retail comprises a "very small part" of the industry); Gibson, *supra* note 2, at 539 (categorizing derivatives players as either dealers, consisting of banks, securities firms and other financial institutions, and end-users, consisting of sophisticated institutions such as corporations and government entities).

5. *See* George Crawford & Bidyut Sen, Derivatives for Decision Makers 197-98 (1996).

6. *See id.*

7. *See* Culp, Primer on Derivatives, *supra* note 2, at 41. Derivatives enable firms to manage the risks of anticipated expansion by increasing the certainty of the firm's net cash flow. *See id.* Derivatives provide an efficient method for corporations to manage their interest rate and currency risk. *See id.*

The primary reason for the current amount of retail swap activity is low is regulatory, i.e., the regulatory uncertainty concerning privately negotiated derivatives has led to a stalemate between United States regulators and derivative dealers.[8] Regulatory authorities such as the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have insinuated that their jurisdictional authority to regulate consumer activity in securities and futures may extend to any consumer activity in privately negotiated derivatives.[9] Swap dealers, to maintain their current favorable regulatory environment, are willing to at least entertain the idea that the SEC and CFTC do have such authority.[10]

Retail derivative activity is inevitable. Just as swaps have evolved across different currency markets and different underlying indexes, such as commodity and equity,[11] so too will the product evolve from an almost exclusive institutional activity to include retail activity. Cost is no longer a prohibitive factor due to the acceptance and advancement of electronic funds transfers and the Internet.[12] The risk management benefits of derivatives are too substantial to be kept from consumers.

The question that underscores the future of retail derivative activity is how, if at all, it should be regulated. One possible answer is that the current regulatory structure that focuses on institutional regulation is adequate. Another response is that a product regulator such as the SEC, CFTC, or even a yet-to-be-formed derivatives agency may be necessary to protect consumers from fraud and other deceptive mar-

8. *See generally* Christopher L. Culp, *Functional and Institutional Interaction, Regulatory Uncertainty, and the Economics of Derivatives Regulation*, *in* Derivatives Handbook: Risk Management and Control 458, 486-87 (Robert J. Schwartz & Clifford W. Smith, Jr. eds., 1997) [hereinafter Culp, *Functional and Institutional Interaction*] (discussing the regulatory uncertainty for privately negotiated derivatives, as no bright line exclusions exist to definitively place the transactions outside of the regulatory jurisdiction of the securities or commodities laws). Culp asserts that both the regulators and even swap dealers themselves due to their own self-interest, actually promote this uncertainty. *See id.* at 486-87.

9. *See id.* at 481-86.

10. *See infra* Part III.B.2.

11. *See* Kenneth R. Kapner & John F. Marshall, The Swaps Handbook: Swaps and Related Risk Management Instruments 288-89 (1990). Commodity swaps are similar in structure to interest rate swaps. One counterparty to the swap makes payments at a fixed price for a commodity, in return for receiving payments at a variable price of the commodity. The transaction is cash settled, i.e., there is no exchange of the physical commodity. The Chase Manhattan Bank pioneered the first commodity swap in 1986. *See id.*; *see also* Tanya Styblo Beder, *Equity Derivatives for Investors*, *in* Advanced Strategies in Financial Risk Management 223, 223-39 (Robert J. Schwartz & Clifford W. Smith, Jr. eds., 1993) (discussing the evolution and applications of equity swaps). In a common form of an equity swap, one counterparty makes future payments based on an equity index in exchange for receiving future payments in reference to another index, such as a fixed interest rate. *See id.* at 236-38.

12. *See* Crawford & Sen, *supra* note 5, at 198.

ket practices. Increased regulation, however, could increase transaction costs, perhaps driving the derivatives market offshore.

This Note addresses the need for regulation of the evolving retail derivatives market. Part I presents the mechanics of swap transactions. Part II discusses the regulatory jurisdictions of the SEC and the CFTC. Part III analyzes the reasons for the current lack of retail swap activity. Part IV discusses the applicability of the securities and commodities laws to retail swaps. Part V presents arguments against increased regulation of swaps, even if swaps do indeed extend to retail. This Note concludes that further regulation of retail derivatives is unnecessary. The existing regulatory structure has led to the United States' premiere market position.[13]

I. THE MECHANICS OF SWAPS

The fundamental principle of exchange behind swap transactions is quite simple. Even young children on the playground, as they swap items in their lunchbox for those of a friend, demonstrate they understand the principle of exchange. A swap, in its most basic form, is simply an exchange of cashflows.[14] Unfortunately, the press, in their zealousness to portray swaps as "a kind of financial cyberspace" based on "calculations designed and monitored by computer wizards using abstruse mathematical formulas that even their bosses at major trading houses do not really understand," have obscured this simplicity.[15] As one scholar puts it, swaps are frequently viewed as "science run amok, . . . a financial Jurassic Park."[16]

A swap is a bilateral contract between two parties (counterparties)[17] to exchange or swap defined cashflows at specified intervals.[18] The cashflows can be determined in reference to an interest rate, foreign currency, equity or an equity index, commodity, etc. The most frequently transacted swap is the interest rate swap, in which cash-

13. *See* Philip McBride Johnson, *Relying on Consumer Protection Laws*, Futures Industry, Feb./Mar. 1999, at 18, 20 (stating that, "The United States cannot risk losing its pre-eminence as a financial center simply to make work for the CFTC.").

14. *See* Satyajit Das, Swap Financing-Interest Rate and Currency Swaps, LTFX, FRAs, Caps, Floors and Collars: Structures, Pricing, Applications and Markets 17 (1989) [hereinafter Das, Swap Financing].

15. John Greenwald, *The Secret Money Machine*, Time, Apr. 11, 1994, at 28, 30. One reporter has admitted that a financial product, "if it's complex, . . . [is] apt to get the name [derivative]." Carol J. Loomis, *Untangling the Derivatives Mess*, Fortune, Mar. 20, 1995, at 50, 54.

16. Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 Tex. L. Rev. 985, 989 (1995) [hereinafter *Hedging Expectations*].

17. *See* Ravi E. Dattatreya et al., Interest Rate & Currency Swaps: The Markets, Products and Applications 12 (1994).

18. *See id.* at 1.

flows are determined in reference to two different interest rates.[19] The most simple of these, a "plain vanilla" or "fixed-for-floating" swap,[20] involves the exchange of cashflows determined in reference to a fixed rate of interest for cashflows determined in reference to a floating rate of interest.[21]

A specific application of an interest rate swap provides the best insight into its mechanics. Corporation A has a loan at a fixed rate of interest. The firm believes interest rates will fall, and would rather have the interest payments on its loan pegged to a floating interest rate. The floating interest rate payments will enable Corporation A to reduce its future borrowing costs if indeed it is correct and interest rates fall over the life of the loan. Corporation B has a loan at a floating rate of interest. This corporation, in contrast to Corporation A, believes future floating interest rates will rise, and thus would rather lock in its future interest payments at a known fixed rate.[22]

Corporation A could achieve its interest rate objectives by first prepaying its existing fixed rate loan and then entering into a new floating rate loan agreement. Similarly, Corporation B could achieve its interest rate objectives by first prepaying its existing floating rate loan and then entering into a new fixed rate loan agreement. The prepayment of debt and the negotiation of a new loan agreement, however, can involve substantial transaction costs and take considerable time, at which point the market may have moved unfavorably against the corporations. On the other hand, an interest rate swap allows each corporation to achieve its financial objectives while leaving the existing loan agreements in place.[23] Under the terms of the swap contract, Corporation A agrees to pay to Corporation B interest at the floating rate that exists on B's floating rate loan. In return, Corporation B agrees to pay to Corporation A interest at the fixed rate of interest that exists on A's fixed rate loan. The swap agreement, through a separate legal contract, transforms each corporation's net interest payments, leaving the initial loan agreements intact, thereby lowering transaction costs and execution time.[24]

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19. *See* Edward S. Adams & David E. Runkle, *The Easy Case for Derivatives Use: Advocating a Corporate Fiduciary Duty to Use Derivatives*, 41 Wm. & Mary L. Rev. (forthcoming 1999) (manuscript at 12, on file with the *Fordham Law Review*).

20. *See id.* (manuscript at 12).

21. *See id.* (manuscript at 12).

22. *See* Das, Swap Financing, *supra* note 14, at 31-32.

23. *See id.* at 216-21.

24. *See id.* at 33. The swap is a legal contract completely independent of the underlying borrowing agreements of Corporations A and B. The institutions that provided the original loans to Corporations A and B are not parties to the swap. Corporations A and B, despite entering into the swap agreement, continue to be obligated to their distinct institutional lender for the payment of the principal and interest. The lenders may even be unaware of the swap contract between Corporations A and B. *See id.*

In the same manner that an interest rate swap can transform interest payments from fixed to variable payments or vice versa, a currency swap transforms currency payments from one currency to another.[25] Although the volume of outstanding interest rate swaps dwarfs the volume of currency swaps,[26] the currency swap actually evolved first.[27] The concept of currency swaps originated from the sterling and United States dollar parallel loans arranged between British and American entities in the 1970s.[28] The loans evolved as a method of avoiding the United Kingdom's foreign exchange controls that had been implemented to deter the outflow of capital.[29] These parallel loans required that a United States parent corporation have a subsidiary in the United Kingdom in need of local funds and, simultaneously, that a United Kingdom parent corporation also have a subsidiary in the United States in need of local funds.[30] Two loans were actually involved in the parallel loan.[31] Under the terms of the first loan, the United States parent corporation would lend the funds it has raised in the United States dollar market to the United Kingdom subsidiary.[32] Under the terms of the second loan, the United Kingdom parent firm would lend an equivalent amount of pound sterling it has raised in its domestic market to the United States subsidiary.[33] As a result of this arrangement, the British and American parent corporations were able to indirectly access the other country's capital market to fund their overseas subsidiaries, circumventing the foreign exchange controls.[34]

Currency swaps are similar in structure to parallel loans,[35] with one exception—the counterparties do not lend currencies to each other.[36] Under a currency swap, the two currencies are not loaned, but are exchanged with a simultaneous commitment to reverse the exchange of currencies at the maturity date of the transaction.[37] The currency amounts to be exchanged, both at inception and maturity, are determined by the spot-exchange rate set at the time of execution of the

25. *See* Dattatreya, *supra* note 17, at 47.

26. *See* International Swaps and Derivatives Association, Inc., *Summary of Market Survey Statistics: 1997 Year End.* The survey reports that at the end of 1997, the notional principal amount of interest rate swaps outstanding was approximately $22 billion, in contrast to $1.8 billion of currency swaps. *See id.*

27. *See* Das, Swap Financing, *supra* note 14, at 5-6.

28. *See id.*

29. *See* Kapner & Marshall, *supra* note 11, at 6.

30. *See* Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 Md. L. Rev. 1, 49 (1996).

31. *See id.*

32. *See id.*

33. *See id.*

34. *See id.*

35. *See* 1 Satyajit Das, Swaps & Financial Derivatives: The Global Reference to Products, Pricing, Applications and Markets 66 (2d ed. 1994) [hereinafter Das, Global Reference].

36. *See id.*

37. *See id.*

swap.[38] In addition to the initial and final exchanges of principal, the currency swap involves interest payments.[39] The interest payments can be based on a floating or fixed rate basis.[40]

Interest rate and currency swaps fall under the broader umbrella term "derivative."[41] A derivative is conventionally defined as a financial instrument or bilateral contract that "derives" its value from the changes in value of other financial instruments or underlying reference price, rate, or index.[42] Derivatives can be classified into three broad categories: derivative securities, exchange-traded derivatives, and over-the-counter ("OTC") privately negotiated derivatives.[43] A particular derivative transaction, depending upon which category it falls, will be labeled as either a security, future, or privately negotiated contract.[44] The label is tremendously important because it ultimately determines what regulatory regime governs the derivative transaction.[45]

Derivatives, whether a security with an embedded derivative, futures contract, or privately negotiated contract, are actually either a forward contract, option contract, or a combination of both.[46] Derivative transactions that are constructed from forwards include forward contracts themselves, swap contracts, exchange-traded futures, and securities with embedded forwards.[47] Derivative transactions that are constructed from options include privately negotiated option contracts, exchange-traded options, and securities with embedded options.[48]

Under the terms of a forward contract, the counterparties determine a set price, amount, and date in the future at which one counterparty will buy, and the other will sell, a specific underlying asset.[49] The forward contract requires actual delivery of the underlying asset by the seller to the buyer.[50] Forward contracts exist for agricultural and physical commodities, currencies (foreign exchange forwards), and interest rates.[51] A forward contract changes in value as

38. *See* Kapner & Marshall, *supra* note 11, at 281.
39. *See* Das, Global Reference, *supra* note 35, at 67.
40. *See id.*
41. *See* Martin Mayer, The Bankers: The Next Generation 289 (1997).
42. *See* Global Derivatives Study Group, Group of Thirty, Derivatives Practices and Principles 28 (1993); Adams & Runkle, *supra* note 19, at 4.
43. *See* Saul S. Cohen, *The Challenge of Derivatives*, 63 Fordham L. Rev. 1993, 2000-01 (1995); *supra* note 2.
44. *See* Global Derivatives Study Group, *supra* note 42, at 29.
45. *See* Cohen, *supra* note 43, at 1994.
46. *See* Global Derivatives Study Group, *supra* note 42, at 29-30.
47. *See id.* at 29.
48. *See id.* at 29-30.
49. *See id.* at 30.
50. *See* Adams & Runkle, *supra* note 19, (manuscript at 6).
51. *See* Global Derivatives Study Group, *supra* note 42, at 30.

the underlying asset changes in value.[52] The terms of a forward contact are not standardized, but are customized to meet a couterparty's financial and/or business objectives.[53]

The other fundamental derivatives contact, the option contract, grants its holder the right, but does not obligate him, to buy or sell the underlying asset (or cash settle) at a specified price, either over a defined time period or on a set date.[54] The option purchaser can forego his right of exercise and let the option expire.[55] The buyer of an option benefits as the price of the underlying asset increases, but does not incur a loss if the price of the underlying asset falls.[56] In contrast to the buyer of the option, the seller of the option has the obligation to perform, that is, buy or sell the underlying asset if the option holder exercises the option.[57]

Derivative securities can embed forwards, options, or a combination of the two.[58] An example of a derivative security that contains a series of foreign exchange forwards is a dual currency bond.[59] A dual currency bond is a bond that pays interest in one currency and principal in another.[60] For example, a United States dollar/Swiss franc dual currency bond would pay interest in Swiss francs, but principal in United States dollars.[61] Implicit in this security is a series of Swiss franc/United States dollar forward foreign exchange contracts.[62] Examples of derivative securities that contain options are "callable" and "putable" bonds.[63] A callable bond gives the issuer the right to buy back the bond from the holder at specific times in the future at a set price.[64] The issuer in effect has purchased a call option from the holder of the bond.[65] In contrast, the holder of a putable bond has purchased a put option from the issuer.[66] This put gives the holder the right to sell the bond back to the issuer at specific times in the future at a set price.[67]

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52. *See id.*
53. *See id.*
54. *See id.* at 32.
55. *See id.*
56. *See id.*
57. *See* Charles W. Smithson, *A Building Block Approach to Financial Engineering: An Introduction to Forwards, Futures, Swaps and Options* 6 (CIBC Wood Gundy School of Financial Products, reprinted from Midland Corporate Finance Journal, Winter 1987).
58. *See* Global Derivatives Study Group, *supra* note 42, at 29.
59. *See id.*
60. *See* 1 Das, Global Reference, *supra* note 35, at 453.
61. *See id.*
62. *See id.*
63. *See* Global Derivatives Study Group, *supra* note 42, at 29.
64. *See* John Hull, Introduction to Futures and Options Markets 342 (1991).
65. *See id.*
66. *See id.*
67. *See id.*

A futures contract is similar to a forward contract in that the buyer of a futures contract also has the obligation to purchase a specified asset at a specified price on the contract maturity date.[68] Futures contracts, however, are standardized rather than custom-tailored, and can only be traded on an organized exchange.[69] The contracts are standardized as to quantity and quality of the underlying asset, price fluctuations, delivery terms and specifications, maturity, and payment.[70] Because futures are standardized contracts that trade on an exchange, the parties settle the contracts for the cash value of the contract rather than an actual transfer of the underlying asset as in a forward contract.[71] An example of an exchange-traded future is a United States Treasury bond future traded on the Chicago Board of Trade.[72]

Futures can be combined with options to create options on futures contracts.[73] If the option on the futures contract is exercised, the underlying futures contract must be delivered.[74] As taking or making delivery of an actual underlying asset can be inconvenient, the options on a futures contract as it requires delivery of simply the futures contract itself, is often preferred to a direct option on the underlying.[75] An option contract on the United States Treasury bond futures contract is an example of an option on a futures contract.[76]

Swaps, which are one form of privately negotiated derivatives, can be broken down into a series of forward contracts.[77] For example, interest rate swaps involve the exchange of specified cashflows, i.e., interest payments, on set forward payment dates.[78] Each one of these

68. *See* Smithson, *supra* note 57, at 2.

69. *See* Adams & Runkle, *supra* note 19, (manuscript at 7).

70. *See id.* at 8; Global Derivatives Study Group, *supra* note 42, at 32.

71. *See* Adams & Runkle, *supra* note 19, (manuscript at 8). The law has not given the term futures contract a precise definition, although one characteristic that is important to courts is whether the contract is offset or settled for cash rather than taking actual delivery of the underlying asset. *See* Culp, *Primer on Derivatives*, *supra* note 2, at 63. This characteristic is the basis for the Forward Contract Exemption under the Commodity Exchange Act ("CEA"). *See* 7 U.S.C. § 1(a)(11) (1994) ("The term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."); Culp, *Primer on Derivatives*, *supra* note 2, at 62. This exemption is a statutory exclusion. *See id.* There is no precise method for determining which transactions are covered by this exclusion. *See id.* at 63. There are three characteristics, however, that will increase the probability that a forward contract is likely to fall under the exclusion. First, the parties must intend physical transfer of the actual underlying commodity, i.e., they must actually expect to make or take actual delivery. Second, the parties must enter into the contracts for "commercial purposes." Finally, in addition to *intending* to make or take actual delivery, the parties must also *have the ability* to make or take delivery. *See id.*

72. *See* Global Derivatives Study Group, *supra* note 42, at 29.

73. *See* Hull, *supra* note 64, at 264.

74. *See id.*

75. *See id.* at 265.

76. *See id.*

77. *See* Global Derivatives Study Group, *supra* note 42, at 31.

78. *See* McLaughlin, *supra* note 2, at 70.

forward future interest payments can be broken down from the swap into an individual and unique forward contract.[79] Other privately negotiated derivatives can be option-based rather than forward-based and include swaptions,[80] caps,[81] floors,[82] collars,[83] and other option products.[84] This Note uses the term "swap" generally to refer to all privately negotiated derivative instruments whether forward- or option-based. Most of the analysis of this Note, however, concerns swaps in the specific sense, as it is anticipated that swaps, rather than option-based transactions, will comprise the majority of future retail activity as is currently the case in the institutional market.[85]

There is no doubt that swaps currently enjoy a more favorable regulatory environment than do their exchange-traded and securities-linked brethren. Indeed, "[t]here is no market regulator for swaps, like the SEC for securities or the CFTC for futures, and some swaps participants are not regulated by the federal government at all."[86] Swap participants desperately want to keep this regulatory framework. As one dealer put it, "[i]t is a great environment because it means greater reliance on market discipline. . . . [Further i]t provides additional choices to market participants."[87] Part II examines the current regulatory framework of swaps.

II. REGULATORY FRAMEWORK

During the early 1980s, swaps avoided regulatory scrutiny.[88] The regulation that did exist was primarily institutional, i.e., regulation of

79. *See id.*

80. A swaption is an option (the right but not the obligation) to enter into a swap. The buyer of a swaption can exercise his right, on a set forward date, to enter into a swap whose terms were known and specified at the time the swaption was transacted. *See* Kapner & Marshall, *supra* note 11, at 519.

81. A cap is a series of forward period cash settled options on an underlying index. The cap buyer receives a payment (exercises the period option) whenever the underlying index exceeds the cap level on an exercise date. *See id.* at 503.

82. A floor is a series of forward period cash settled options on an underlying index. The floor buyer receives a payment (exercises the period option) whenever the underlying index falls below the floor level on an exercise date. *See id.*

83. A collar is the purchase (sale) of a cap and a simultaneous sale (purchase) of a floor. *See id.*

84. *See* Cohen, *supra* note 43, at 2001.

85. *See* International Swaps and Derivatives Ass'n, Inc., Summary of Market Survey Statistics: 1997 Activity. The survey only measures interest rate swap, currency swap, and interest rate option activity. *See id.* Other privately negotiated derivative transactions, such as commodity and equity swaps, are not surveyed due to the significantly lower volume of transactions as compared with interest rate and foreign exchange derivatives. *See id.* The survey reports that in 1997, 77% of the surveyed privately negotiated derivatives executed that year were interest rate swaps; 5% were currency swaps; and 18% were interest rate options. *See id.* at 1.

86. Graham Cooper, *Uncertainty Mounts for U.S. Swappers,* RISK, July 1998, at 20, 23.

87. *Id.*

88. *See* 2 Das, Global Reference, *supra* note 35, at 1354.

the financial institutions dealing in derivatives rather than the product itself. As swap activity grew, however, and began to encompass transactions in reference to commodity and equity indexes, the financial product regulators, the SEC and the CFTC, began to address whether they might have regulatory jurisdiction over the activity. This part discusses the evolution of the existing regulatory framework for swaps and the growing involvement of the CFTC and SEC.

A. *Early Regulatory Structure*

After observing IBM execute the first widely publicized currency swap with World Bank in 1981,[89] few, if any, would have predicted that the volume of privately negotiated derivatives outstanding would grow to almost $29 trillion in 1997.[90] In the early 1980s, most of the swap activity involved currency swaps that enabled large international borrowers to engage in capital markets/new issue arbitrage.[91] In a capital markets/new issue arbitrage transaction, a synthetic liability is created by combining a new debt issue with a concurrent currency swap to provide a cost of funds that is less than if the issuer had raised funds directly in the relevant market.[92] Prior to the advent of currency swaps, corporate and institutional borrowers generally borrowed funds in their domestic market, as they did not want to be exposed to the risk of unfavorable foreign exchange movements incurred if they borrowed abroad.[93] Through a currency swap, however, United States corporations, for example, could borrow funds in an overseas capital markets, such as Switzerland, and simultaneously transform the Swiss-franc-denominated debt into a synthetic dollar obligation at a funding rate well below what they could achieve directly in United States capital markets.[94] Over time, the savings achievable through capital markets arbitrage greatly declined as swap activity led to greater market efficiency.[95] Today, capital markets arbitrage activity, although still capable of creating a fleeting moment of

89. *See* Das, Swap Financing, *supra* note 14, at 6.

90. *See* International Swaps and Derivatives Ass'n, ISDA Survey Shows Swaps Volume Rose 13% to $28.7 Trillion in First Half of 1997; New Business Activity Climbed 46%, at 1 (unpublished news release, Jan. 12, 1998). To say the least, the wide-ranging financial applicability of swaps and the tremendous advances in portfolio risk management techniques and computer/systems technology that would enable high volume activity, were not anticipated. *See* Crawford & Sen, *supra* note 5, at 67 (discussing the importance of computer sophistication in the growth of derivatives); 1 Das, Global Reference, *supra* note 35, at 19-28 (discussing the factors behind the rapid growth of swaps).

91. *See* Das, Swap Financing, *supra* note 14, at 168.

92. *See id.* at 183-214.

93. *See id.* at 168.

94. *See id.*

95. *See id.* at 171. It is possible to arbitrage across the different capital market because the price of capital is not consistent at all times. *See id.* at 168.

opportunity, only accounts for a small portion of current transactions.[96]

Participants began to realize swaps' strength as an inexpensive and flexible asset-liability management vehicle.[97] The use of swaps in risk management has led to their almost exponential growth over the past decade.[98] Corporate treasurers can now easily alter existing fixed-rate debt into floating-rate debt, at a cost generally lower than that of retiring the existing fixed rate debt and negotiating and executing a new floating rate borrowing.[99]

During the early 1980s, swap transactions primarily involved interest rates and foreign currencies, and the product "developed under negligible regulatory attention."[100] A swap, branded neither as a security nor a futures contract, was free of the exchange-trading requirements of the Commodity Exchange Act ("CEA"),[101] the registration requirements of the Securities Laws,[102] and the antifraud and antimanipulation prohibitions of both.[103] Because many of the major swap dealers were commercial banks, however, their swap activity was subject to federal banking regulations.[104] In addition to examinations by federal bank regulators, the regulations have both mandated reporting and capital requirements.[105] The annual regulatory examination, although primarily focused on bank practices and policies regarding risk management, also included a review of swap activity.[106] Under the reporting requirements, the banks provided information concerning their total swap positions as measured by notional amount and an estimated risk value.[107] The banks were also required to meet a specific core capital to total assets leverage ratio.[108]

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96. *See* 1 Das, Global Reference, *supra* note 35, at 629.

97. *See* Das, Swap Financing, *supra* note 14, at 172-73.

98. *See* Carolyn H. Jackson, *Legal Challenges for the Millennium: A Speculation*, 7 J. Fin. Engineering 203, 205 (1998).

99. *See* Das, Swap Financing, *supra* note 14, at 172-73.

100. *See id.* at 540.

101. 7 U.S.C. §§ 1–26 (1994).

102. 15 U.S.C. §§ 77–78 (1994).

103. *See* McLaughlin, *supra* note 2, at 182.

104. *See* Romano, *supra* note 30, at 59.

105. *See id.*

106. *See id.*

107. *See id.* at 59-60.

108. *See id.* at 61. Prior to 1988, swaps and other off-balance sheet financial instruments were free of bank regulatory capital requirements. In 1988, the Basle Accord was negotiated by the Bank for International Settlements (BIS), United States banking regulators, and banking regulators from many other nations. The Basle Accord imposed risk-based capital requirements on swaps and other off-balance sheet financial products. The capital provides a reserve against potential losses that would arise from a couterparty default (credit risk). The Basle Accord became fully operative in 1992. *See id.* In 1993, the BIS wrote a proposal that the capital requirements be extended to include the market risk arising from swap transaction and other off-balance sheet financial instruments. *See id.* at 62.

B. *Assertion of CFTC and SEC Regulatory Jurisdiction*

In the late 1980s, the swaps world changed dramatically, as the swap product evolved to include commodity- and equity-linked indexes.[109] Both the CFTC and the SEC began to obliquely assert that they had regulatory jurisdiction over some or all of the growing and highly profitable swap activity.[110] For example, in 1987, in response to reported commodity swap activity by The Chase Manhattan Bank, N.A. (Chase), the CFTC stated that it was analyzing whether it should regulate commodity swaps.[111] The CFTC hinted that it might declare commodity swaps to be illegal, unauthorized, off-exchange futures contracts.[112] Simultaneously, the CFTC launched an enforcement investigation of Chase's commodity swap activity.[113]

1. Historical Background of the SEC and CFTC

a. *The SEC*

Although the issue of a required disclosure system for United States securities had been debated since the early twentieth century, it was only after the market collapse in October 1929 and the Great Depression that there was any true political impetus for congressional action.[114] The Federal Securities Act of 1933 ("'33 Act") was enacted to regulate the offering and sale of securities to the public.[115] Under the '33 Act, disclosure requirements were created to address the abuses of the 1920s, including the fraudulent sale of securities.[116] The '33 Act requires disclosure of the public offering of securities through the process of registering the offering.[117] The registration statement aims to provide full and fair disclosure of the particular public offering of securities.[118] The registration statement requires issuers to disclose all of the significant details of their underlying business.[119]

The devastating economic effects of the Great Depression extended beyond the purchasers of new issues.[120] Holders of outstanding securities suffered severe and painful financial losses.[121] Although much of the 1929 stock market crash was due to speculative frenzy, abusive

109. *See supra* note 11 and accompanying text.
110. *See infra* notes 154-56, 173-80, and accompanying text.
111. *See* Romano, *supra* note 30, at 55.
112. *See id.*
113. *See id.*; *supra* note 11 (describing commodity swaps).
114. *See* James D. Cox et al., Securities Regulation: Cases and Materials 3 (2d ed. 1997).
115. *See id.*
116. *See id.*
117. *See id.* at 4.
118. *See id.*
119. *See id.*
120. *See id.* at 5.
121. *See id.*

trading and market manipulation practices played a role as well.[122] In response to these concerns, Congress passed the Securities Exchange Act ("'34 Act") to protect the public against abusive stock practices.[123] The '34 Act created the Securities and Exchange Commission to enforce compliance with the '33 and '34 Acts.[124]

b. *The CFTC*

During the early 1800s, United States farmers and agricultural merchants used futures contracts to protect against price fluctuations of agricultural commodities.[125] These contracts were established through informal negotiations between merchants and farmers.[126] With time, centralized markets, or exchanges, such as the Chicago Board of Trade, began to develop.[127] These exchanges offered standardized contracts for agricultural commodities that could be bought and sold in the future, replacing the informal negotiations between merchant and farmer.[128] But many were opposed to the exchanges' intense speculative nature. For instance, in 1921, a United States Senator commented that the Chicago Board of Trade was "so much of a 'gambling hell' that 'Monte Carlo or the Casino at Havana are not to be compared to it.'"[129] Public outcry against the perceived speculative abuses of both the exchanges and futures activity that was off-exchange, such as bucket shops,[130] led Congress to enact the Futures Trading Act[131] ("FTA") in 1921.[132] The FTA sought to halt price manipulation and bucketing by levying a prohibitive tax on any grain futures that were off-exchange and therefore not under the supervision of the Secretary of Agriculture as a "contract market."[133]

The following year, the Supreme Court ruled that a portion of the FTA was unconstitutional; the tax on off-exchange grain futures transactions represented an improper exercise of Congress's taxing

122. *See id.* at 5-6.
123. *See id.* at 6-7.
124. *See id.* at 7-9.
125. *See* Thomas A. Tormey, Note, *A Derivatives Dilemma: The Treasury Amendment Controversy and the Regulatory Status of Foreign Currency Options,* 65 Fordham L. Rev. 2313, 2323 (1997).
126. *See id.*
127. *See id.*
128. *See id.*
129. *See* Culp, Primer on Derivatives, *supra* note 2, at 61 (citation omitted).
130. Bucket shops claimed to execute futures transactions for the public. The bucket shop merchant, however, "bucketed" trades, meaning that he took the customer order but did not register them with any board of trade or exchange. Rather, if the value of the contract fell, he would collect from the customer. If the value of the contract increased, such that the customer was owed money the bucket shop would disappear, avoiding paying the customer. *See* Mayer, *supra* note 41, at 329.
131. Ch. 86, 42 Stat. 187 (1921).
132. *See* Tormey, *supra* note 125, at 2324.
133. *See id.*

power.[134] Congress responded by enacting the Grain Futures Act of 1922,[135] relying on an exercise of congressional power under the Commerce Clause[136] to once again try to prohibit all off-exchange futures activity.[137]

During the Great Depression, commodity prices experienced a devastating collapse.[138] In response to suspicions that the collapse had been caused by speculative trading on the futures exchanges, Congress substantially revised the Grain Futures Act in 1936 through the Commodity Exchange Act ("CEA").[139] The CEA set regulatory standards for transactions in certain specified commodities[140] as well as criminal sanctions for commodity price manipulation, either actual or attempted.[141]

The CEA remained virtually unchanged for the following thirty-five years.[142] In 1974, however, Congress significantly revised the CEA ("1974 Act")[143], primarily in response to increasing public participation in commodity markets.[144] The amendments created the CFTC as an independent agency, "ostensibly . . . [in] the desire to expand regulatory coverage to then-unregulated futures trading, which included several contracts on nonagricultural products, such as silver and foreign currency futures, as well as internationally grown agricultural products like coffee and sugar."[145] Congress granted the CFTC exclusive jurisdiction over futures contracts on all commodities.[146] In addition to increasing the number of commodities covered by the CEA,

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134. *See* Hill v. Wallace, 259 U.S. 44, 68-69 (1922).

135. Ch. 369, 42 Stat. 998 (1922).

136. U.S. Const. art. I, § 8, cl. 3. The Commerce Clause gives Congress the authority "to regulate Commerce . . . among the several States . . . ." *Id.*

137. *See* Tormey, *supra* note 125, at 2325. The constitutionality of the Grain Futures Act was upheld by the Supreme Court in 1923. *See* Board of Trade v. Olsen, 262 U.S. 1 (1923).

138. *See* Tormey, *supra* note 125, at 2325-26.

139. Ch. 545, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. §§ 1–26 (1994)); *see* Tormey, *supra* note 125, at 2325.

140. Commodity Exchange Act, § 3(a) (1936). According to the CEA, "[t]he word 'commodity' shall mean wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs and Solanum tuberosum (Irish potatoes)." *Id.*

141. Commodity Exchange Act, § 9 (1936).

142. *See* Tormey, *supra* note 125, at 2326.

143. 7 U.S.C. §§ 1–26, (1994).

144. *See* Tormey, *supra* note 125, at 2326-27.

145. Romano, *supra* note 30, at 22. Prior to the 1974 Act, the administration of the CEA had been overseen by the Secretary of Agriculture. *See* Tormey, *supra* note 125, at 2327.

146. *See* 7 U.S.C. § 2(i). This section provides, in pertinent part:

> The [CFTC] shall have exclusive jurisdiction . . . with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option . . ."), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 7 of this title or any other board of trade, exchange, or market . . . .

Id.

the 1974 Act broadened the definition of commodity to include "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[147] This broadened language suggested that in addition to having complete jurisdiction over agricultural futures, the CFTC would also have complete jurisdiction over financial futures.[148] The CFTC's regulatory authority derives from the 1974 Act's requirement that all futures trading be "conducted on an agency-authorized contract market or exchange (board of trade)."[149] According to the 1974 Act, CFTC approval is required before any futures contract can be traded.[150] Further, CFTC regulations require any exchange offering a futures contract be an authorized board of trade.[151] Among the 1974 amendments to the CEA, Congress included the Treasury Amendment[152] to provide the Department of Treasury with the assurance that the "large off-exchange foreign currency market that had developed among various commercial banks, multinational corporations, and sophisticated investors" would be excluded from the CEA.[153]

2. Early CFTC and SEC Regulatory Assertion

The swap industry's ongoing regulatory jurisdictional struggles with the CFTC have, at least according to the CFTC, given the agency regulatory authority over any future retail swap activity.[154] Despite the

147. 7 U.S.C. § 1(a)(3); *see also supra* note 140 (providing the original 1936 definition of commodity).

148. *See* McLaughlin, *supra* note 2, at 188. Today, transactions in financial futures dominate the activity of the exchanges—not transactions in agricultural futures. *See* Global Derivatives Study, *supra* note 42, at 32.

149. Romano, *supra* note 30, at 23.

150. *See id.*

151. *See id.*

152. 7 U.S.C. § 2(ii). The Treasury Amendment provides:

> Nothing in this chapter [the CEA] shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

Id. The Treasury Amendment is a statutory exclusion and therefore all transactions that fall within the Treasury Amendment are not "covered by the CEA *at all* and thus are subject neither to the exchange-trading (or contract market) requirements nor to CEA antifraud and antimanipulation provisions." McLaughlin, *supra* note 2, at 185 (emphasis in original).

153. *See* Tormey, *supra* note 125, at 2326-28.

154. In a December 1997 address at Fordham Law School, the Honorable Brooksley Born, Chairperson of the Commodity Futures Trading Commission, stated:

> The Commodity Exchange Act grants the Commission exclusive jurisdiction over futures and commodity options, whether they are traded on-or-off exchange, and authorizes the Commission to enforce the federal commodities laws with respect to such instruments. Using powers granted to the Commission by Congress in 1992, the Commission has exempted certain over-the-counter transactions primarily between sophisticated traders, from

existence of the Treasury Amendment, the CFTC has asserted that it has regulatory jurisdiction over retail activity in both forward and option foreign currency contracts.[155] In a 1985 CFTC statutory interpretation, the agency stated that the Treasury Amendment was limited to transactions between "sophisticated and informed institutions" and did not extend to "marketing to the general public."[156]

With regard to swap transactions, in 1989 the CFTC backed off from its view that it had jurisdictional authority over commodity swaps, and issued a policy statement[157] that provided a safe harbor for most swaps from CFTC jurisdiction.[158] The Commission ruled, however, that "[s]wap transactions eligible for safe harbor treatment may not be marketed to the public."[159] The banking industry, dissatisfied with the CFTC's Swap Policy Statement, lobbied Washington for a bill that would exclude swaps from the CEA.[160]

The banking industry's lobbying efforts ultimately resulted in an exemption and not an exclusion.[161] The Futures Trading Practices Act,[162] effective October 1992, amended the CEA to authorize the CFTC to grant exemptions from essentially all of the CEA's provi-

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many of the regulations and provisions of the Commodity Exchange Act, including the on-exchange requirement.

Brooksley Born, Keynote address at the Derivatives & Risk Management Symposium at Fordham University School of Law (1997), *reprinted in* 66 Fordham L. Rev. 761, 761-62 (1997).

155. *See* Culp, *Functional and Institutional Interaction*, *supra* note 8, at 479. A foreign currency option is an option, the underlying value of which is pegged to the price of a particular currency. *See* Tormey, *supra* note 125, at 2316 n.5; *see also supra* notes 54-57 and accompanying text (discussing options generically).

A currency forward is a forward contract, the underlying value of which is pegged to the price of a particular currency. As with other forward contracts, the foreign currency forward is a customized transaction. *See* Tormey, *supra* note 125, at 2316 n.11; *see also supra* notes 49-53 and accompanying test (discussing forwards generically).

156. Joanne T. Medero, *The Great Treasury Amendment Debate*, Futures Industry, Mar. 1997, at 19, 19.

157. CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (1989). Specifically, the Policy Statement provided: "This statement reflects the Commission's view that at this time most swap transactions, although possessing elements of futures or options contacts, are not appropriately regulated as such under the Act and regulations." *Id.*

158. *See* Romano, *supra* note 30, at 55.

159. 54 Fed. Reg. 30,697 (1989).

160. *See* Romano, *supra* note 30, at 56.

161. *See* Office of the General Counsel, Securities and Exchange Comm'n, *Recent Legislative Developments Affecting the Work of the Securities and Exchange Commission*, *in* The SEC Speaks in 1998, at 469, 529 (PLI Corporate Law & Practice Handbook Series No. 1037, 1998). An exclusion is preferable over an exemption because it provides certainty that swaps are excluded from the provisions of the CEA. "[A]n exemptive approach . . . could allow some market participants to argue later that, because swaps are exempted from the CEA, they are futures; otherwise, no exemption would have been necessary." *Id.*

162. Pub. L. No. 102-546 (1992), 106 Stat. 3590, 3629.

sions.[163] In January 1993, the CFTC exercised its new authority, exempting certain types of swaps from most of the requirements of the CEA, including the exchange-trading requirement, but not from the antifraud and manipulation provisions of the CEA,[164] in what has now become known as the Swaps Exemption.[165] The exemption, however, is limited to very sophisticated participants.[166]

The CFTC recently tried to establish broad regulatory authority over privately negotiated derivatives in its May 1998 Concept Release.[167] Although the CFTC claimed that the purpose of the release was to solicit widespread commentary on the adequacy of the swap and other exemptions from the CEA, some regarded it as a step toward CFTC swap regulation.[168] The questions asked in the release "made it clear that the [CFTC] was looking for reasons to justify extending its regulatory reach to include this market."[169] The Federal Reserve, SEC, and Treasury have "condemned" the Concept Release.[170]

Unlike the CFTC, the SEC's assertion of regulatory jurisdiction over swaps has been more circumspect. Further, its assertion of authority has largely occurred in relation to its ongoing turf battles with the CFTC. Following the 1987 stock market break, the jurisdictional dispute between the SEC and the CFTC intensified,[171] as each agency implicated the other in regulatory oversight.[172] The numerous reports and studies concerning the appropriate regulatory structure for stock index futures and other derivative products called into question SEC and CFTC regulatory jurisdiction over equity swaps.[173] A market that had largely developed outside of regulatory scrutiny found itself at center stage in the lengthy and ongoing turf battle between the SEC and CFTC, as well as in the ongoing debate as to whether the United States financial markets should be regulated functionally, institutionally, or through some combination of both approaches.[174]

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163. 7 U.S.C. § 6(d) (1994); *see* Culp, Primer on Derivatives, *supra* note 2, at 66.

164. 7 U.S.C. § 6(d); *see* Romano, *supra* note 30, at 56.

165. 17 C.F.R. § 35 (1996).

166. *See id.* § 35.1(b)(2). The Swaps Exemption only applies to eligible swaps participants. *See id.*

167. Over-the-Counter Derivatives, 63 Fed. Reg. 26,114 (1998) (to be codified at 7 C.F.R. pts. 34 & 35).

168. William P. Albrecht, *Reforming U.S. Regulatory Structure*, Futures Industry, Feb./Mar. 1999, at 14, 15.

169. *Id.*

170. *See* McLaughlin, *supra* note 2, at 189.

171. *See* John D. Benson, Comment, *Ending the Turf Wars: Support for a CFTC/SEC Consolidation*, 36 Vill. L. Rev. 1175, 1190 (1991).

172. Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development, in* Advanced Strategies in Financial Risk Management, *supra* note 11, at 439, 442.

173. *See id.* at 442 n.8.

174. *See generally* Christopher L. Culp, Competitive Enter. Inst., *Regulatory Uncertainty and the Economics of Derivatives Regulation,* Financier: ACMT, Dec. 1995, at

Recently, the SEC, due to what it perceived to be reprehensible sales practices, asserted regulatory jurisdiction in its enforcement action against Bankers Trust Securities Corp. ("Bankers Trust").[175] In its release detailing the enforcement action, the SEC charged Bankers Trust with violating the securities laws, asserting that certain swap transactions they had entered into with Gibson Greeting Cards ("Gibson") were not swaps but securities as defined under the '33 Act.[176] The SEC provided no specific basis for its finding.[177] In fact, the release states that the underlying securities upon which the market value of the Gibson swaps depended, United States government securities and options on those securities, are specifically exempted by the SEC.[178] Although it is unlikely that the SEC's assertion that the swap transactions were securities would have been upheld in court,[179] Bankers Trust agreed to settle with the SEC paying a civil penalty of ten million dollars.[180] Building upon the analysis of the regulatory structure of swaps discussed in part II, part III addresses both current and future retail swaps activity.

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46 [hereinafter Culp, *Regulatory Uncertainty*] (discussing functional and institutional regulation and the overlap between the two forms). As articulated by Culp, financial regulation comes in two types: functional and institutional. *See id.* at 53. Functional regulation purports to regulate the economic functions that the financial system provides, such as capital formation and hedging. *See id.* at 55. The SEC and the CFTC are functional regulatory regimes. *See id.* In contrast, institutional regulation purports to regulate the institutions that provide financial activities. *See id.* at 53. Commercial bank regulation by the Federal Reserve Board, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency exemplify institutional regulation. *See id.* at 54.

In response to significant losses by corporations and institutional entities allegedly due to their activity in derivatives. *see infra* note 435, Congress has debated whether a functional regulator should be created for all derivative activity. One such proposal was the Risk Management Improvement and Derivatives Oversight Act of 1995, which called for the establishment of a Federal Derivatives Commission for the purpose of setting oversight standards for financial institutions engaged in derivative transactions. *See* H.R. 20, 104th Cong., (1995); Thomas C. Singher, Note, *Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative See to Congressional Action?*, 18 Fordham Int'l L.J. 1397, 1438-42 (1995).

Nobel Laureate Merton Miller predicts that proposed efforts to redraw United States regulatory jurisdictions along logical functional lines would ultimately end in regulatory dysfunction. *See* Merton H. Miller, *Functional Regulation, in* Derivatives Handbook: Risk Management and Control *supra* note 8, at 446, 457.

175. *See* McLaughlin, *supra* note 2, at 183, 239-40.

176. *See* Culp, *Regulatory Uncertainty*, *supra* note 174, at 63-64.

177. *See* Romano, *supra* note 30, at 58. Romano states, "Indeed, the release is internally incoherent." *Id.*

178. *See id.*

179. *See id.*

180. *See In re* BT Securities Corp., Exchange Act Release No. 35,136; 58 SEC Docket 1182 (Dec. 22, 1994). The $10 million dollar payment made pursuant to the SEC order also satisfied Bankers Trust's obligation under a related CFTC opinion and settlement order. *See id.* at 1193.

III. Retail Swaps Activity

Largely due to the regulatory uncertainty of SEC and CFTC regulatory jurisdiction over swaps, retail swap activity, to date, has been minimal at best. This part discusses an early attempt to establish a consumer derivative product through a certificate of deposit with an embedded derivative, a prediction of the future form of retail derivatives, and the reasons behind the current lack of consumer swap activity.

A. *An Early Consumer Derivative: The S&P Indexed CD*

In 1986, the treasurer and the officer in charge of new product development for the swaps group at Chase[181] designed a derivative product that was ideal for those individuals who want to participate in the equity markets, but ultimately decide not to, because of the potential loss of their principal.[182] The product the two Chase bankers designed was a certificate of deposit ("CD") that paid interest at a rate based in part on changes in the Standard and Poor's 500 Composite Stock Index ("S&P Index").[183] Basically, a consumer would purchase a CD from Chase by placing his money on deposit.[184] The interest payable, rather than being a money market rate, would be a return based either on the gains of the S&P 500 Index or a Guaranteed Return.[185] At the CD's maturity, the consumer would be credited with interest at either the S&P Index Return or the Guaranteed Return, whichever was higher.[186] If the S&P Index decreased or failed to increase during the term of the CD, the S&P Index Return was put at zero, and the depositor received the Guaranteed Return.[187] Regardless of the performance of the S&P Index, the depositor receives full return of his principal at maturity.[188] Although the S&P CD looks relatively

181. *See* Office of the Comptroller of the Currency, Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A., to Offer the Chase Market Investment Deposit Account 1 (1988) [hereinafter OCC Interpretive Letter], *available in* 1988 WL 282282. In March 1987, Chase began offering time deposits known as the Market Index Investment deposit which paid interest at a rate based upon the Standard and Poor's 500 Composite Stock Index (S&P Index). *See id.*

182. *See* Joseph P. Ogden, *A Strategic Analysis of Stock Index-Linked CDs*, *in* Derivatives, Regulation and Banking 193, 206 (Barry Schachter ed., 1997).

183. *See* Eugene H. Cantor & Barry Schachter, *Indexed Certificates of Deposit*, *in* Derivatives, Regulation and Banking, *supra* note 182, at 159, 162. The S&P Index, which is listed on the New York Stock Exchange, consists of an index of 500 stocks of generally the largest firms that is weighted by market value. *See id.* at 162 n.5. The value of the S&P index is determined by comparing the current aggregate market value of the 500 stocks against a 1940 base index. *See id.* at 162-63 n.5.

184. *See id.* at 162-63.

185. *See id.* at 163. The Guaranteed Return was similar to a fixed interest rate, and could be set at various levels, such as two percent, four percent, or zero. *Id.*

186. *See id.*

187. *See id.*

188. *See id.*

straightforward, to make the product available to the consumer, Chase had to hedge its exposure to the S&P through various hedges such as futures contracts on the S&P Index.[189]

One month after Chase launched the S&P Indexed CD, however, the Investment Company Institute ("ICI") brought suit in the District Court of the District of Columbia against Chase.[190] The ICI claimed that the Chase S&P Indexed CD was a security, placing it outside of Chase's banking authority under the Glass-Steagall Act.[191] The case was ultimately resolved in Chase's favor in 1995.[192]

Undeniably, the S&P Indexed CD makes sense: "From 1926 to 1995, returns on stocks have dwarfed all other common asset classes: the compound annual growth rate on large company stocks was 10.5%, as against . . . 3.7% for [United States] Treasury Bills."[193] Further, the S&P Indexed CD does not seem likely to lead to a high incidence of fraud or large consumer losses. In fact, its purpose is to reduce risk and the possibility of loss by allowing individuals to invest in the equity market without risking their principal.[194] Yet, due to regulatory uncertainty, the innovative S&P Indexed CD was burdened with litigation that contributed to delayed consumer acceptance.[195]

189. For a thorough discussion of the hedging of S&P Indexed CDs see Ogden, *supra* note 182, at 194-05, and OCC Interpretive Letter, *supra* note 181, at 13-21.

190. *See* OCC Interpretive Letter, *supra* note 181, at 1. The Investment Company Institute (ICI) is the American trade association of the investment company industry, whose membership consists primarily of open-end investment companies. It members also include closed-end investment companies and unit investment trusts. *See* John E. Baumgardner, Jr. & Paul N. Roth, *Developments in the Regulation of Offshore Investment Funds and Other International Investment Vehicles; Developments in International Advice Regulation*, 1077 PLI/Corp 303, 339 n.1 (1998).

191. *See* OCC Interpretive Letter, *supra* note 181, at 1-2; 12 U.S.C. § 24 (Seventh) (1994).

192. *See* Cantor & Schachter, *supra* note 183, at 162 n.4.

193. Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 Geo. L. J. 2319, 2368-69 (1996) [hereinafter Hu, *Illiteracy and Intervention*].

194. *See supra* notes 182-88 and accompanying text.

195. In the ICI's charges against Chase for offering the S&P Indexed CDs, it stressed that one of the reasons the CD was outside of Chase's banking authority was due to the fact that Chase used S&P Indexed futures to hedge its position. *See* OCC Interpretive Letter, *supra* note 181, at 13-16. The use of stock-indexed futures is regarded by many as one of the main factors behind the stock market crash of October 19, 1987. *See* Robert J. Barro et al., Black Monday and the Future of Financial Markets 364 (1989).

Despite its ominous origins, S&P indexed CDs are now offered by many institutions. These institutions include Bankers Trust, Citibank, Republic New York, Merrill Lynch, Paine Webber, Salomon Brothers, and Warburg and Co. *See* Ogden, *supra* note 182, at 193 & n.1. CDs can have their return tied to indexes other than equity. Examples include commodity-linked CDs whose returns are keyed to increases in the price of gold or other commodities, or commodities indexes and bonus CDs whose return increase when particular events occur, "such as the victory of a particular football team in the Superbowl or the occurrence of a prescribed minimum amount of rainfall or snowfall in the issuing bank's local area." Cantor & Schachter, *supra* note 183, at 159.

B. *Why Current Consumer Swap Activity Is Minimal*

The primary reasons behind the lack of consumer activity are the regulatory uncertainty and the desire of swap dealers to preserve the current favorable regulatory structure that exists for swaps, at least at the wholesale level. Although the extension of swaps to retail participants was formerly cost prohibitive in the developmental stages of the product, technological advances have made consumer derivatives viable.

1. Legal Uncertainty

The term "legal certainty," in the context of swaps, is used to mean absolute assurance that swaps are unequivocally outside the reach of both the CFTC and the SEC.[196] A finding to the contrary would have a devastating, "death penalty" effect on the activity by making the contracts illegal and thus unenforceable.[197] This is because the contracts would violate either the exchange-trading requirement of the CEA or the registration requirement with the SEC.[198] Swap counterparties would have an easy way to walk out on their contractual financial obligations.[199] In addition, a determination that a swap is a futures contract would necessitate restructuring the contract to trade on an exchange and would eliminate one of the swap's primary advantages—its ability to be exactly tailored to a customer's objectives. Finding a swap to be a security, on the other hand, would require that all swap contracts be registered with the SEC, as well as subject them to the antifraud provisions of the '33 Act and the '34 Act.[200] Further, bank subsidiaries could be required to register as broker-dealers with the SEC and thus be subject to the SEC capital

196. *See* McLaughlin, *supra* note 2, at 189.

197. *See* Roger L. Anderson, *The Treasury Department's Role in Regulating the Derivatives Marketplace*, 66 Fordham L. Rev. 775, 777 (1997).

198. *See* McLaughlin, *supra* note 2, at 167, 184-85.

199. *See* Culp, *Functional and Institutional Interaction*, *supra* note 8, at 463. A counterparty to a swap has an incentive to walk away from the contract when the underlying index of the contract has moved against them. *See id.* Even a swap counterparty who is using a swap as a hedge and not as a speculation can have the incentive to walk away from a swap contract that is in a loss position, claiming, for example, it is an illegal off-exchange futures contract and therefore unenforceable, allowing him to benefit from a gain on his underlying position. In such a case, by walking away from the swap contract, the swap counterparty will be left with a windfall gain on his underlying position. *See* Hull, *supra* note 64, at 129-32 (discussing a fundamental principal of hedging that the gains (loss) on a hedge offset the loss (gains) of the underlying transaction).

200. *See* McLaughlin, *supra* note 2, at 184.

rules.[201] Finally, swap counterparties would have standing to sue the dealers for fraud under Rule 10b-5 of the '34 Act.[202]

It has been alleged that the CFTC purposely fosters an atmosphere of legal uncertainty.[203] The uncertainty enables them to give lip service to managing three fundamental but often incompatible objectives: (1) to take action against after any perpetrators of fraudulent activity or price manipulation in the financial or commodity markets; (2) to provide assurance to privately negotiated derivatives that the product is essentially outside of the CEA; and (3) to reassure that the exchange-trading requirement will be upheld for futures contracts.[204]

Some regulators and most swap dealers advocate that further regulation of privately negotiated derivatives is unnecessary because only sophisticated institutions enter into swap agreements.[205] Sophisticated institutions operate on an arms-length, counterparty basis, and have the financial acumen and resources to seek recourse through common law fraud and contract remedies.[206] Thus, they do not need the added protection of regulation by the SEC or CFTC. This argument has always been troublesome because it fails to look to the future. It seems peculiar to base a regulatory framework on the presumption of a static world that will never evolve to include retail.

2. Status Quo Protectionism

At times, it appears that some swap dealers are willing to accept the CFTC's assertions of retail jurisdiction and sacrifice any future development of retail derivatives product to the authority of the CFTC and perhaps the SEC, so that the current favorable regulatory treatment of swaps will be preserved. For example, in an amicus brief on writ for certiorari in *Dunn v. Commodity Futures Trading Commission*,[207] many leading derivatives-interested trade associations conceded that "a holding by this Court that the phrase 'transactions in foreign cur-

201. Should a derivative be declared a security, derivative dealers would be required to register the transactions under the Acts, and be subject to the SEC's net capital rules as contained in Rule 15c3-1 under the Exchange Act. *See* 17 C.F.R. § 240.15c3-1 (1997).

202. *See* McLaughlin, *supra* note 2, at 184.

203. *See* Alton B. Harris, *The CFTC and Derivative Products: Purposeful, Ambiguity and Jurisdictional Reach*, 71 Chi.-Kent L. Rev. 1117, 1166 (1996).

204. *See id.*

205. *See* Culp, Primer on Derivatives, *supra* note 2, at 85; *supra* note 4 and accompanying text. Some however, have conceded the possibility that retail derivatives whether exchange-traded or privately negotiated may develop, but such a development in their view should lead to the development of a two-tiered institutional/consumer regulatory structure. *See* Filler, *supra* note 4, at 22 (arguing that derivatives regulation should be less stringent for institutional participants); Tormey *supra* note 125, at 2371-73 (supporting a "safe-harbor of maximum legal certainty for the Interbank industry," while supporting CFTC regulation of retail foreign exchange option activity).

206. *See* Tormey, *supra* note 125, at 2350-51.

207. 58 F.3d 50 (2d Cir. 1995).

rency' includes foreign currency options does not mean that the mass-marketing of those instruments to the general public will not be subject to the [Commodity Exchange Act] (CEA)."[208] *Dunn* is a leading case in defining the CFTC's regulatory authority over derivatives, specifically foreign currency options.[209] The defendant asserted that the CFTC had no authority to bring a cause of action against him because the Treasury Amendment excluded foreign exchange transactions from regulation under the CEA.[210] The Second Circuit found for the CFTC, holding that an option on foreign currency is not a transaction in foreign currency until it is exercised.[211]

It seems unfortunate and premature that so many leading trade associations were willing to possibly concede defeat on the regulatory structure of a market that has not yet emerged in order to maintain the regulatory status quo for the known institutional market. Swap dealers must become more affirmative in their arguments that the current regulatory framework can include future retail activity. If swap dealers continue to confine their argument against regulation to the sophistication of institutional players, they forego the opportunity to structure a swap to meet consumer objectives. Swaps will not be "developed to be efficient, to meet investors' needs, and to enhance [United States] competitiveness in the world financial market."[212] Rather, the question will be whether retail swaps will ever be offered at all by United States dealers due to the continuing struggle between the CFTC and the SEC over the scope of each agency's jurisdiction over new financial products and their concern to protect retail customers.

3. Fixed Costs of Swap Transactions

In addition to regulatory uncertainty and status quo protectionism, cost has also been a factor in the curtailing of retail product activity. A swap is not a one-time transaction; it is a financial risk position that must be managed over the life of the transaction.[213] Thus, swap deal-

208. Amicus Brief for the Foreign Exchange Committee, Dunn v. Commodity Futures Trading Comm'n, 117 S. Ct. 913 (1997) (No. 95-1181), *available in* 1996 WL 392512, at *27. The trade associations were The Foreign Exchange Committee, The New York Clearing House Association, The Futures Industry Association, The Managed Futures Association, and The Public Securities Association. *See id., available in* 1996 WL 392512, at *1.

209. 58 F.3d 50.

210. *See id.* at 53.

211. *See id.* In 1997, the Supreme Court reversed the Second Circuit's opinion, holding that foreign currency options fell under the Treasury Amendment and were therefore excluded form CFTC jurisdiction. *See* Dunn v. Commodity Futures Trading Comm'n., 117 S. Ct. 913, 917 (1997).

212. *See* Russo, *supra* note 172, at 439.

213. *See* 2 Das, Global Reference, *supra* note 35, at 1237. An individual swap can create a large number of cashflows. For example, a swap with a five-year maturity structured to have semi-annual interest payments will involve 10 settlement payments,

ers incur substantial fixed costs in managing their businesses.[214] These costs include trading, marketing, hedging, credit, risk management, operations technology, regulatory, and legal costs.[215]

One of the early hurdles to the establishment of the swap product was actually legal.[216] Legal costs of documenting the transactions were substantial because each time a transaction was executed each dealer would write and negotiate an entirely new document, establishing new definitional and mechanical terms.[217] Over time, the process of "legal innovation" led to the development of standardized Master Agreements.[218] All transactions with one counterparty were documented under the Master Agreement.[219] Master Agreements revolutionized the legal environment for swaps as they allowed the transactions between counterparties to be combined as one net exposure rather than as a number of separate exposures.[220] This "legal innovation" alleviated the risk that in bankruptcy a trustee would only recognize the swap transactions under which the defaulting couterparty was owed a payment while ignoring those under which it was required to make a payment.[221] These standard contracts are known as the International Swaps and Derivatives Association, Inc.

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10 resets to determine the appropriate floating cashflows, and 10 calculations of the net settlement amount. *See id.* at 1237-38.

214. *See* Robert M. Mark, *Risk Oversight for the Senior Manager: Controlling Risk in Dealers*, *in* Derivatives Handbook: Risk Management and Control, *supra* note 8, at 354, 401.

215. *See id.* (discussing the development of a model for senior management to take explicit account of trading, marketing, hedging, credit, risk management, operations technology, regulatory, and legal costs in the pricing of derivative transactions); *see also* 2 Das, Global Reference, *supra* note 35, at 1237-64 (providing a thorough analysis of the multitude of costs incurred by a financial firm in maintaining an ongoing derivatives operation). Das divides the costs across three structural areas: (1) front office; (2) middle office; and (3) back office. *See id.* at 1241. Among the front office costs are the costs of the traders and salesman, the dealing room, trade brokerage commission, systems for pricing, hedging, risk management simulation, and client relationship management. *See id.* at 1240-44. The middle office costs include the costs of producing risk, profit and loss, general ledger, credit, and market data reports as well as the costs of the underlying technological support systems. *See id.* at 1241. The back office costs include the systems necessary to generate trade confirmations, notifications, and the resets on underlying variable indexes. *See id.*

216. *See* Kapner & Marshall, *supra* note 29, at 429.

217. *See id.*

218. *See id.* at 429-31. One scholar espouses the theory that as financial innovation has led to the creation of derivatives, derivatives in turn have led to a process of "legal engineering" and "legal innovation." *See* McLauglin, *supra* note 2, at 1, 159. He states, "A modern paradigm of legal innovation is the development of the standard industry form 'master agreements' that now pervade both OTC derivatives and other financial market." *Id.* at 159. McLauglin notes that without the development of this legal engineering to remove the uncertainty concerning the key terms and conditions underlying swap transactions, the growth of the product would have been substantially curtailed. *See id.*

219. *See id.* at 432.

220. *See id.* at 433.

221. *See id.*

("ISDA") Master Swap Agreements.[222] Although the agreement is standardized, it also contains a Schedule in which all unique terms between the couterparties are negotiated.[223] Arriving at a final Master Agreement often involves extensive negotiations, as the agreement is intended to encompass all future swap transactions between the two counterparties.[224]

As swaps have evolved and their returns narrowed, it has become critical for swap dealers to be able to both finely price and hedge the transactions,[225] which involves substantial expenditure in computer technology. It requires computers with the fastest calculating and processing times.[226] Swap dealers employ "rocket scientists" to develop the complex financial models behind the products' valuations and hedging.[227] Before a customer executes a swap, he is provided with numerous trading ideas and market analyses.[228] After a trade is executed, customers frequently require market valuations of their existing transaction as well as future market analysis.[229] Customers require traders to provide indicative price quotations on transactions they are considering, but may ultimately not execute.[230] Firms expend substantial marketing and trading costs for any executed transaction. As swaps are risk-managed collectively in a portfolio, the risks in the portfolio are ongoing and need to be managed with each change in market conditions.[231] Substantial time and technology resources are devoted to hedging the market risks of the swap portfolio.[232]

During the initial phase of development of swaps, as with any new product, the returns generated were substantial.[233] As the activity ma-

222. *See* Ian Wallace, *Legal and Documentation Issues of Swaps and Financial Derivatives*, *in* 2 Das, Global Reference, *supra* note 35, at 1341, 1343-45. Master Swap Agreements were developed by representatives from the leading dealer banks (commercial and investment banks) in a trade association, the International Swap Dealers Association. *See* Kenneth R. Kapner & John F. Marshall, The Swaps Handbook: Swaps and Related Risk Management Instruments 562-63 (Supp. 1992). The trade association later changed its name to The International Swaps and Derivatives association, Inc. *See* 2 Das, Global Reference, *supra* note 35, at 1440.

223. *See* Wallace, *supra* note 222, at 1344. The ISDA Master Agreements are structured to contain only fundamental operational terms and conditions. The Schedule gives the parties the ability to modify the core document. The legal matters that are addressed in the Schedule include whether there are any specified entities, cross default provisions, credit support agreements, governing law, or early termination considerations. *See id.* at 1344-45.

224. *See* 2 Das, Global Reference, *supra* note 35, at 1246.

225. *See id.* at 1254.

226. *See id.*

227. *See* Greenwald, *supra* note 15, at 32.

228. *See* 2 Das, Global Reference, *supra* note 35, at 1241-42.

229. *See id.* at 1242.

230. *See id.* Ultimately, the consumer may not execute these hypothetical transaction and indicative quotes. *See id.*

231. *See id.* at 1020-21.

232. *See id.* at 954-55.

233. *See* 1 Das, Global Reference, *supra* note 35, at 18.

tured, swaps "evolved into competitive, transparent, liquid, and increasingly 'commoditized' markets in which bid-offer spreads . . . have declined . . . precipitously . . . ."[234] In today's competitive environment, a swap dealer earns, at most, one to three basis points per year on the underlying notional principal amount of a "plain vanilla" transaction.[235] Thus, on a three-year, $100 million transaction, a swap dealer will take in at most, $82,000 in revenue.[236] On a consumer transaction on a notional principal amount of $1000, the dealing institution would only take in eighty-two cents. Thus, consumer swap transactions will only be profitable to swap dealers if they can access a high volume of activity in a low cost manner.

The expansion of swaps into the consumer arena would establish "market completeness" for what Robert Merton defines as the financial innovation spiral.[237] He posits that as new financial products enter the market, their volume will expand, which in turn "reduces marginal transaction costs . . . which in turn leads to still more volume . . . spiraling toward the theoretically limiting case of zero marginal transaction costs and dynamically complete markets."[238] The high volume of institutional swaps has led to legal, financial, and, most importantly, technological innovations that have lowered the fixed costs of swap transactions.[239] These cost reductions, combined with the cost reductions available through electronic funds transfers and the Internet, have made offering swaps to individuals feasible.[240]

234. McLaughlin, *supra* note 2, at 17; *see* 1 Das, Global Reference, *supra* note 35, at 28-29.

235. *See* 1 Das, Global Reference, *supra* note 35, at 162 (detailing the bid-ask spread carried on an electronic pricing screen for United States dollar interest rate swaps); Culp, Primer on Derivatives, *supra* note 2, at 7 (defining a plain vanilla swap as an interest rate swap in which one party pays a fixed rate and the other party pays a floating rate indexed to prevailing interbank Eurodeposit rate, the London Interbank Offered Rate (LIBOR)). A basis point is an interest rate equal to one one-hundredth of one percentage point, i.e., 0.01 percent. *See* Kapner & Marshall, *supra* note 11, at 485.

236. This calculation is performed on a present value basis, discounted annually at five percent.

237. McLaughlin, *supra* note 2, at 16.

238. *Id.* (quoting Robert C. Merton, *Financial Innovation and Economic Performance*, J. Applied Corp. Fin., Winter 1992, at 4).

239. *See id.* at 16-17, 19.

240. *See* Philip S. Corwin, *The Virtual Dotted Line: Understanding Digital Signatures*, Banking Pol'y Rep., Feb. 17, 1997, at 1, 1 ("According to many observers, the explosion of digital commerce facilitated by the Internet is simply a matter of when, not if."). At the American Banking Association convention in 1995, the biggest draw among the convention's proffered demonstrations was that of personal banking in the future. *See The Rubber Meets the Road*, Economist, Sept. 16, 1995, at 87, 87 ("Using a computer mouse, one can walk from the shopping mall into the bank and conduct financial business."). It has been observed that:

> As the Web develops, consumers [will] take control of their own financial destinies, national boundaries [will] be removed, distinctions between financial products [will] evaporate and broad offices, administrative centers and piles of marketing literature [will] disappear. . . . [A] customer in Australia,

C. *The Future Structure of Retail Derivatives*

The cost savings afforded by derivatives as a risk management instrument are significant. As one commentator has observed, "[f]undamentally, swaps represent perhaps the most significant financial innovation in capital markets in the latter half of the 20th century. . . . Swaps serve to foster more rapid growth in . . . capital flows allowing the channeling of excess savings in one market to another."[241] Swaps significantly lowered corporate funding costs by enabling corporate borrowers to have access to new foreign capital markets through eliminating unwanted foreign exchange risk. The benefits of altering the nature of the interest payments or investment returns of an underlying borrowing or investment, without having to first cancel the initial transaction and renegotiate the replacement transaction, are clear. There seems to be no reason as to why this flexibility and cost savings should be denied to consumers. For example, enabling consumers to re-balance their investments and borrowings through swaps would provide consumers with greater financial flexibility and tailored risk management.[242] Consider an individual who has a fixed rate mortgage but who would now prefer to make his interest payments on a variable rate basis. Currently, the consumer would have to prepay his existing fixed rate mortgage and negotiate a new variable rate mortgage agreement. Consumer swaps would allow the individual to effect this change without prepayment through the convenience of an ATM or the Internet. Consumers as investors, make asset class decisions.[243] Swaps would allow consumers to instantaneously alter their asset class allocations without incurring the costs

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> using only his television set [will] obtain his pension in the [United States], buy a German bond in Frankfurt and invest in a tax-exempt scheme in Dublin.

Scott Andersen, *Calculating Net Worth*, Private Banker Int'l, July 1, 1997, at 15, *available in* 1997 WL 12398033.

The Internet volume for United Stated stocks is estimated to be $3.2 billion a day. *See* Perri Colley McKinney, *A New Breed of Investment Company Is Introducing the Masses to Currency Trading, Once the Province of the Rich Internet Forex Attracts Smaller Players*, S. China Morning Post, Oct. 4, 1998, at 9, *available in* 1998 WL 22021545. According to a survey conducted by the Bank Marketing Association, financial websites were visited by 70% of online consumers in 1996 and 34% used financial websites regularly. *See* Bernadette Tracy, *New Customers Are Waiting Online at the Electronic Banking "Window": 1997 Could Be the Year of "Electronic Commerce"*, Bank Mkt., Jan. 1, 1997, at 8, *available in* 1997 WL 10172531. A survey revealed that 46% of the people interviewed went online to get help in making their financial decisions, such as buying CDs and mutual funds. Additionally, 31% of these financial "surfers" bought financial products at retail. *See id.*

241. Das, Swap Financing, *supra* note 14, at 651.

242. *See* Crawford & Sen, *supra* note 5, at 198-99.

243. *See infra* Part V.D.

of actually liquidating the underlying investment and simultaneously contracting to enter into a new investment.[244]

Since the inception of privately negotiated derivatives, many have viewed the extension of derivatives into the consumer arena as inevitable.[245] As Bidyut Sen, former managing director and co-head of the World Wide Derivative Products Group at Morgan Stanley & Co., has stated, "[i]t is possible . . . banks could provide a range of derivative-based investment options: perhaps even through ATMs. For example, a person could stop at the corner ATM and transfer funds into a principal-protected S&P 500 fund."[246]

Opponents of the extension of derivatives into the consumer world state that derivatives are simply too complex and that consumers will never participate in an activity they do not understand.[247] But, it is unnecessary and sometimes impossible for an individual to comprehend the technical mechanics and operations of a derivatives transaction.[248] For example, while most individuals know how to operate a car, few "know how the internal combustion engine works or how transmissions are put together."[249] Most homeowners have experience with mortgages that contain periodic or lifetime caps, although very few of them probably understand the fundamentals of cap pricing, hedging, or trading.[250] Further, it does not seem too complex for a consumer in the Chase S&P example to understand switching his return from a money market to an equity base.

This Note predicts that the following structure will develop for consumer derivatives: (1) the consumer will place a minimum notional principal amount on deposit with a financial institution; (2) the financial institution will pay a defined periodic interest to the individual at a money market yield; if the financial institution approves the credit risk of the individual,[251] he will then be authorized to enter into a

244. Retail participation in energy derivatives through the Internet is also being forecasted. *See* Douglas F. John & Ronald S. Oppenheimer, *The Commodization of Energy*, Nat. Resources & Env't, Spring 1998, at 251, 251. The authors discuss that it may not be long before homeowners "sit down at [their] personal computer screens and order $100 worth of 'cold' or 'hot' from a supplier of [their] choice." *Id.* This is because various technological developments have led to the "commoditization" of energy which has in turn led to the development of a derivatives products that will ultimately extend to the consumer. *See id.* 251, 254.

245. *See* Filler, *supra* note 4, at 21 (stating that "the retail . . . population could increase both in number and trading volume as electronic trading interfaces are created to permit direct access . . . to anyone owning a PC.").

246. *Id.* at 198; *see supra* Introduction. Such a fund is comparable to the Chase S&P Indexed CD. *See supra* notes 181-95 and accompanying text.

247. *See* Crawford & Sen, *supra* note 5, at 198.

248. *See id.*

249. *Id.*

250. *See id.*

251. *See Status of ATMs Under State Branching Laws: Hearings on S. 2898 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong. 113 (1984) [hereinafter *ATM Hearings*] (noting that banks are already able to extend credit risk

variety of asset class swap transactions, where the numeraire (base index against which other asset class alternatives are priced) will be the CD money market yield; and (3) prior to the execution of the first swap transaction, the customer and the financial institution will negotiate and execute a highly customized Master Swap Agreement to suit both the individual's creditworthiness and financial objectives, dovetailing what exists in the institutional market.

For example, the consumer could enter into an equity swap contract with the financial institution. Under the terms of the contract, the individual would agree to pay to the financial institution the money market yield he was earning on his CD in return for receiving the return on the S&P 500 index over a defined time period, plus or minus a spread. Thus, in addition to the certificate of deposit, there would also exist a swap contract between the financial institution and the consumer documenting the equity swap.

Further, the individual, through either the Internet[252] or an ATM,[253] could enter into a second swap transaction to transfer his interest payments back to either a money market yield or the return on a global fund index or other asset class. Confirmations of the transactions could be generated at the exact same time the swap is transacted, either through the Internet or at the ATM. To assure themselves of the best price, individuals would negotiate Master Swap Agreements with various financial institutions. Thus, if a consumer did not like the spread he was receiving on the S&P index in exchange for the money market yield he was receiving from one bank, he could transact with another bank if the latter provided a better spread.

The tremendous expansion of swap activity in the institutional arena is due to technology.[254] Technology takes two forms: hardware (computers and other electronic networks) and software (financial engineering).[255] Swap dealers have been able to offer larger volumes of derivatives transactions due to the development of technology systems

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to consumers through ATMs as evidenced by the set up of cash advances against pre-approved credit lines).

252. Consumer enthusiasm for executing financial transactions can be gathered by looking to other markets such as electronic securities trading. "On-line securities trading grew 181[%] to 26 million transactions in 1997 and should gain another 91[%] this year." Susan Abbott Gidel, *Shifting Markets: Internet Use Growing*, Futures Industry, Apr./May 1998, at 14, 14.

253. ATMs first appeared in 1969 and grew to 2900 by the end of 1974. They were initially regarded with skepticism, as it was thought that consumers might not necessarily trust transactions through a machine over those with an actual person. *See ATM Hearings*, *supra* note 251, at 58. "These figures . . . underscore the public acceptance of, and reliance upon, the convenient services that ATM's and shared ATM networks provide." *Id.* at 59.

254. *See* Crawford & Sen, *supra* note 5, at 67, 197.

255. *See id.* at 197. "The growth of . . . derivatives owes much to modern finance theory and to the speed, power, and widespread availability of computers." *Id.* at 67.

that enable them to inexpensively revalue and re-hedge their portfolios in real time.[256]

Cost is no longer a prohibitive factor to offering retail derivatives, as "[t]he derivatives technology as well as the network technology for [consumer derivatives] already exists."[257] It is a natural evolution in financial product development that when the costs of providing what has been an exclusively institutional financial product fall significantly, the product will become available to retail investors.[258] One example is provided by the Liberty Loan program of 1917, instituted during World War I by the United States Government. The government attempted to fund its wartime efforts by selling small-denominated bonds to "a new clientele: retail investors."[259]

> The Treasury immediately decided to mount an intensive nationwide sales effort. Advertisements and thousands of spokesmen emphasized the security, high yield, and probable appreciation of the new Liberty bonds. Established techniques were put aside. Instead of selling substantial amounts of large denominations for holding in relatively few hands, the government issued bonds in small denominations, utilized war savings stamps widely, and permitted installment payments. All the foregoing "new" departures were designed to appeal to individuals not considered potential investors since the Civil War days of Jay Cooke.[260]

The marketing and sale of treasury securities to individuals as well as institutional players was a natural development in the establishment of market completeness.[261] The extension of swaps to consumers is similarly an inevitable part of the process of market completeness. Of course, along with this process comes the inevitable government desire to regulate. Part IV discusses the applicability of SEC and CFTC regulation to retail swaps.

IV. APPLICATION OF SEC/CFTC REGULATION TO RETAIL SWAPS

One of the initial hurdles retail derivatives must overcome is avoiding SEC and CFTC jurisdictional claims, which are made simply because they involve retail activity. Although there are no bright line

256. *See* McLaughlin, *supra* note 2, at 17; *see also* 2 Das, Global Reference, *supra* note 35, at 950-55 (discussing the evolution of swaps from a fully matched brokered business to one of market making and portfolio management).

257. Crawford & Sen, *supra* note 5, at 198. A former chairman of the CFTC, Philip McBride Johnson comments, "cyberspace will make [derivatives] readily available to traders world wide." Johnson, *supra* note 13, at 20.

258. *See* Peter Tufano, *Securities Innovations: A Historical and Functional Perspective*, J. Applied Corp. Fin., Winter 1995, at 90, 92.

259. *Id.*

260. *Id.* at 93 (quoting V. Carosso, Investment Banking in America: A History 225 (1970)).

261. *See id.* at 92-93; *supra* notes 237-40 and accompanying text (discussing Robert Merton's "innovation spiral" hypothesis).

rules for determining whether a derivative product is a future, security, or swap, based on current regulation and existing case law retail derivatives should safely remain outside of both SEC and CFTC regulatory jurisdiction. This part discusses the definitional issues surrounding the terms "future" and "security" as well as the implications of the current definitional ambiguity for swaps.

A. *The SEC Has No Regulatory Authority*

1. Definitions

The crucial issue in determining whether retail swaps would be subject to SEC regulatory authority is if the transactions could be deemed a security.[262] Under the '33 Act and the '34 Act (collectively "the Acts"), a security is defined broadly. In the '33 Act, Congress defined the term "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 foreign 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.[263]

Parts of the definition, such as stocks, bonds, notes, and debentures, appear straightforward.[264] Other parts, such as investment contracts and interests commonly known as securities, seem more ambiguous.[265] Certainly, the definition of "security" established in the Acts was not

262. *See* McLaughlin, *supra* note 2, at 183. A financial product is potentially subject to the securities laws and SEC jurisdiction if it falls within the definition of a security. Any swap that has a security or a formula tied to a security as its underlying index is also potentially a security. *See id.*

263. 15 U.S.C. § 77b(1) (1994). The definition section of the '34 Act is virtually identical and encompasses the same instruments as the '33 Act. *See id.* § 78c(a)(10). The '33 Act requires the registration of most securities and disclosure of information specific to the issuing entity. *See* Benson, *supra* note 171, at 1184. The '34 Act created the SEC as an independent, quasi-judicial regulatory agency, charged with the responsibility of "protect[ing] the public from fraud and abuses in the securities markets." *Id.* The SEC does not analyze securities offerings for their economic return; the SEC's premise is that with adequately disclosed information, an investor can make his own judgment on a security's value. *See id.* at 1185.

264. *See* Cox, *supra* note 114, at 117.

265. *See id.*

originally intended to include swaps, since they did not develop until nearly fifty years after the Acts' inception.[266]

Swap contracts could, however, be classified as a security if they are determined to fall under one of the broader components of the Acts' definition—investment contract or note. The Acts do not define these two terms, but the accepted definitions come from two landmark Supreme Court cases. In *SEC v. W. J. Howey Co.*,[267] the Court defined an investment contract as: (1) an investment; (2) in a common enterprise; (3) with the expectation of profit; (4) solely from the efforts of others.[268] And in *Reves v. Ernst & Young*,[269] the Court laid out the framework for defining a note. It adopted the Second Circuit's family resemblance test, ruling that a note is presumed to be a security.[270] That presumption may only be rebutted by showing that the note bears a strong resemblance to an identified list of commonly-denominated notes that fall outside the definition of security.[271] Courts consider the following four factors in determining whether a transaction bears a family resemblance to the excluded list: (1) the motivations of the buyer and seller in entering into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) whether there is an alternative regulatory scheme or risk reducing factor.[272]

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266. *See* McLaughlin, *supra* note 2, at 183-84. McLauglin notes that swaps have traditionally been regarded as a risk management device rather than as capital raising investments. *See id.* Although a small number of swap transactions were executed in the 1970s, swaps were not regarded as an established international capital markets transaction until the August 1981 landmark swap transaction between World Bank and IBM. *See* Das, Swap Financing, *supra* note 14, at 6; *supra* note 89 and accompanying text.

267. 328 U. S. 293 (1946).

268. *See id.* at 299. In *Howey*, investors were offered units of a citrus grove development coupled with a contract for cultivating, marketing, and remitting the net proceeds. *See id.* at 295. The investors provided the capital and shared in the earnings and profits; the promoters managed, controlled, and operated the enterprise. *See id.* at 299. The Court held that an offering of units of a citrus grove development coupled with a service contract was a security under § 2(1) of the '33 Act. *See id.* at 298-300. In *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974), the court modified the third prong of the *Howey* test to eliminate the word "solely." The court held that the securities laws can not be circumvented by requiring investors to nominally participate in the management of their ventures. *See id.* at 480.

269. 494 U.S. 56 (1990).

270. *See id.* at 64-65.

271. The types of notes that are not securities under the Acts are detailed in the case of *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). These notes include notes delivered in consumer financing, notes secured by a home mortgage, short-term notes secured by a lien on a small business or some of its assets, notes evidencing a personal loan to bank customer, short-term notes secured by an assignment of accounts receivables, and notes which are collateralized and formalize an open-account debt incurred in the ordinary course of business. *See id.* at 1138. The court found these notes to essentially be "note[s] or other evidence[s] of indebtedness issued in a mercantile transaction." *Id.*

272. *See* Reves v. Ernst & Young, 494 U.S. 56, 66 (1990).

As swap dealers structure retail swaps, they must ensure that the new product remains outside of SEC regulatory jurisdiction. As one commentator has observed, categorization can make all the difference:

> "Whether a financing transaction is a security is a weighty issue for [swap] participants. If the ['33] Act covers the arrangement, two consequences result. One, the arrangement must be registered with the [SEC], unless an exemption applies. Two, with or without a registration exemption, the antifraud provisions of the ['33] Act and the . . . ['34] Act . . . will apply." Additional complications may also arise. For example, if a swap transaction is deemed to be a security, both parties will "have standing to sue under Rule 10b-5, private placement procedures must be followed more carefully, dealers may have to register as broker-dealers with the SEC, and the SEC's net capital rules may apply to some bank subsidiaries."[273]

Undeniably, if retail swaps are deemed to be securities the regulatory implications are significant.

2. Case Law

One concern facing swap dealers are those swap contracts under which one set of cashflows is determined in reference to a security or a formula that involves the value of a security. Such transactions could potentially themselves be a security as the underlying value of the swap contract is ultimately dependent upon the value of security or formula.[274] Because swaps are a relatively new financial product, however, existing applicable case law is scarce. In *Procter & Gamble Co. v. Bankers Trust Co.*,[275] the court applied the *Howey* and the *Reves* tests to determine that the security-linked, privately negotiated derivatives at issue were not securities.[276] In *Marine Bank v. Weaver*,[277] the Supreme Court held that a conventional bank certificate of deposit and a privately negotiated business agreement between two parties were not securities.[278] This section discusses each case in turn.

a. *Procter & Gamble Co. v. Bankers Trust Co.*

In 1993 and 1994, Procter & Gamble ("P&G") entered into two highly-specialized swap transactions with Bankers Trust. The first, known as a 5s/30s swap, derived its value from a mathematical rela-

273. McLaughlin, *supra* note 2, at 184 (quoting Christopher Olander & Cynthia Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Laws*, 45 Md. L. Rev. 21, 53-54 (1986), and John C. Coffee, Jr., *Bankers Trust Settlement: Whither the Swaps Market?*, N.Y. L.J., Jan. 26, 1995, at 5).

274. *See id.* at 183.

275. 925 F. Supp. 1270 (S.D. Ohio 1996).

276. *See id.* at 1277-83.

277. 455 U.S. 551 (1982).

278. *See id.* at 555.

tionship between yields on five-year Treasury Notes and prices of thirty-year Treasury Bonds.[279] The second transaction, known as a DM swap, was a highly leveraged swap whose value was derived from both a put and a call on Deutsche mark interest rates.[280] As both United States and German interest rates moved against P&G, the company terminated the transactions with Bankers Trust at a loss of over $200 million to P&G.[281] P&G did not pay Bankers Trust.[282] Rather, it brought a cause of action against Bankers Trust alleging, among other claims, violation of the securities laws.[283] In particular, P&G asserted that the two swaps fell within the definition of security as defined as: "(1) investment contracts; (2) notes; (3) evidence of indebtedness; (4) options on securities; and (5) instruments commonly known as securities."[284] The court dealt with each of these allegations in turn, observing that, "[e]conomic reality is the guide for determining whether these swaps transactions that do not squarely fit within the statutory definition are, nevertheless, securities."[285]

First, in determining whether the two swaps could be considered investment contracts, the court restated the *Howey* test, defining an investment contract as "an investment in a common venture premised on a reasonable expectation of profits to be derived for the entrepreneurial or managerial efforts of others."[286] It held that the P&G swaps were not investment contracts because P&G's money was not combined with that of any other entity in a single commercial venture[287] and the "value of the swaps depended on market forces, and not on [Bankers Trust's] entrepreneurial efforts."[288]

The court turned next to analyzing whether the swaps were notes, using the Supreme Court's four part "family resemblance" test established in *Reves*.[289] The court outlined the four factors for consideration: "(1) the motivation of the buyer and seller in entering in to the transaction . . . ; (2) a sufficiently broad plan of distribution . . . ; (3) the reasonable expectations of the investing public; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering the application of the securities laws unnecessary."[290]

279. *See Bankers Trust Co.*, at 1276.
280. *See id.* at 1276-77.
281. *See id.*
282. *See id.* at 1277.
283. *See id.* at 1274.
284. *Id.* at 1277.
285. *Id.*
286. *Id.* at 1277-78 (citations omitted).
287. *See id.* at 1278.
288. *Id.*
289. *See id.*
290. *Id.* at 1278-79.

The court held that the P&G swaps did not meet the first three prongs of the test.[291] The swaps were regarded by the court to be closer to commercial rather than investment contracts as Bankers Trust's motive in transacting the swaps was to earn a fee and P&G's to reduce funding costs.[292] Because the 5s/30s and DM swaps were customized and could only be traded to another counterparty with the agreement of Bankers Trust, the court held they were not part of a general offering to the public.[293] As the swaps were not traded on a national exchange, "the paradigm of a security," they could not reasonably be regarded as securities by the public.[294] On the fourth prong, existing regulatory scheme, the court was divided. It acknowledged that although the transactions fell under the guidelines of the banking authorities, those regulations are generally for the protection of the banks and their shareholders and not their customers.[295] The court ultimately concluded that despite the divided opinion on the fourth prong of the *Reves* test, the P&G swaps did not fall within the statutory definition of a note for purposes of the securities laws.[296]

P&G asserted that the swaps were evidence of indebtedness because they contained bilateral promises to pay money and thus established a debt between the two parties.[297] The court dismissed the claim as it held that the appropriate test was the *Reves* test, which the swaps had already failed.[298] Further, the court stated that as the terms of the swaps did not involve the repayment of principal, they were missing an essential element of a debt instrument.[299] In an interest rate swap transaction, only interest payments and not principal are exchanged.[300]

The court then turned to whether the swaps could be deemed options on securities. The definition of "security" in the Acts added in the 1982 amendments, the parenthetical phrase "including any interest therein or based on the value thereof," which could mean that an option based on the value of a security is a security.[301] The court dismissed the claim by examining the language from the House Report to conclude "the parenthetical phrase . . . was intended only to modify the immediately preceding clause—'group or index of securities'—and not the words 'any option' or 'any security.'"[302] Thc court also held that the swaps were not options as the interest payments under

291. *See id.* at 1279.
292. *See id.*
293. *See id.*
294. *Id.* (citation omitted).
295. *See id.* at 1280.
296. *See id.*
297. *See id.*
298. *See id.*
299. *See id.*
300. *See id.*
301. *Id.* at 1281.
302. *Id.* (citation omitted).

the contracts were required and did not provide for an exercise right or a right to take delivery.[303]

P&G's final contention was that the 5s/30s and DM swap were securities because they were instruments commonly known as securities.[304] The court dismissed this claim, once again applying the *Howey* test as mandated by the Supreme Court.[305]

b. *Marine Bank v. Weaver*

In this case, the Weavers had purchased a $50 million certificate of deposit from Marine Bank, which they later pledged to Marine Bank to guarantee a $65,000 loan made by the bank to a slaughterhouse.[306] The Weavers entered into a privately negotiated agreement with the slaughterhouse, whereby they were to receive half of the slaughterhouse's net profits, $100 per month while the guarantee was in place, use of the slaughterhouse's barn and pasture, and the right to veto future borrowings by the slaughterhouse, in consideration for guaranteeing the bank loan.[307] When the slaughterhouse went bankrupt, the Weavers filed a complaint that Marine Bank had violated § 10(b) of the '34 Act.[308]

The Supreme Court held that neither the CD nor the private agreement was a security.[309] While acknowledging that the "definition of security in the ['34 Act] is quite broad,"[310] the Court was, content with the fact that "in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."[311] The Court held that a CD issued by a federally-regulated bank was not a security and was distinguishable from any other long-term debt obligation commonly found to be a security, due to the existence of extensive banking regulation.[312] The Court held that the privately negotiated contract between the Weavers and the slaughterhouse was also not a security as it was a unique agreement that was not intended to be traded publicly.[313]

B. *The CFTC Has No Regulatory Authority*

The CFTC, created in 1974 to guard the public from fraud and price manipulation in the futures market, is somewhat of a new federal regulator.[314] As early futures contracts were limited to agricultural com-

303. *See id.* at 1281-82.
304. *See id.* at 1282.
305. *See id.* at 1282-83.
306. See Marine Bank v. Weaver, 455 U.S. 551, 552-53 (1982).
307. *See id.*
308. *See id.* at 553-54.
309. *See id.* at 559-60.
310. *Id.* at 555.
311. *See id.* at 556.
312. *See id.* at 557-58.
313. *See id.* at 560.
314. 7 U.S.C. §§ 4b, 4o, 6(c)b (1994).

modities, they were regulated by an entity within the Department of Agriculture.[315] At the time futures regulation was initially enacted in the 1920s, and even at the time of the CFTC's creation in 1974, no one had envisioned the regulation to include swap transactions.[316]

The legal definition of a futures contract is the determinative factor for CFTC jurisdiction under the CEA.[317] While the Act contains no statutory definition of "futures contract,"[318] the term has been regarded to fit broadly into the language of a "contract for the purchase or sale of a commodity for future delivery."[319] The 1974 Act also expanded the definition of commodity to include non agricultural products such as financial products.[320]

The expanded definition of commodity under the 1974 Act, coupled with the vague and broad definition of futures, created substantial legal uncertainty for swap participants.[321] Starting in 1987, when the CFTC began an enforcement investigation into the commodity swap activity of Chase Manhattan,[322] swap participants have actively worked with the CFTC to receive assurance that swaps would continue to fall outside of CFTC regulatory jurisdiction.[323] These industry efforts have resulted in increased legal certainty. The first example came through the issuance of the Swaps Policy Statement that provided a safe harbor for the majority of swap transactions.[324] The second example was the 1993 Swaps Exemption,[325] which exempted "certain classes of investors, specified institutions, and persons with assets over $10 million, from operation of all but the antifraud and manipulation provisions of the CEA."[326]

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315. *See* Romano, *supra* note 30, at 22.

316. *See supra* note 266 (discussing that although a few swap transactions had been executed in the 1970s, 1981 marked the actual beginning of the swap market). It is interesting to observe that a former CFTC chairman, Mary L. Schapiro, has noted that derivatives were not contemplated at the time of the drafting of the CEA. *See* Harris, *supra* note 203, at 1167. In a 1995 speech, she stated that the application of "[the] 'inflexible' [exchange trading] 'requirement to innovative OTC financial products . . . [was] clearly never envisioned [by the law's drafters].'" *See id.* (quoting Chairperson Mary L. Schapiro, Remarks to the National Capital of the National Association of Business Economists (Feb. 15, 1995)).

317. *See* Romano, *supra* note 30, at 24.

318. *See id.* at 25.

319. Culp, Primer on Derivatives, *supra* note 2, at 62.

320. The original definition of commodity under the CEA was limited to agricultural products. *See supra* note 140. In 1974, the definition was broadened with language that could cover financial futures as well. *See supra* note 147 and accompanying text (providing the broadened definition of commodity).

321. *See* Culp, Primer on Derivatives, *supra* note 2, at 62.

322. *See infra* notes 384-87, and accompanying text.

323. *See* Romano, *supra* note 30, at 55; *supra* Part II.B.

324. CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (1989).

325. CFTC Exemption of Swap Agreements, 17 C.F.R. § 35 (1996).

326. 7 U.S.C. § 6(d) (1994); *see* Romano, *supra* note 30, at 56. Romano notes that the exemption was limited—prohibiting swaps to be structured as standardized con-

Legal uncertainty remains for swap participants, however, because the CFTC's Swap Exemption "does not settle whether swaps are futures contracts within the meaning of the CEA."[327] While the CFTC did not determine that swaps are futures, it is troubling that Congress granted the CFTC exemptive authority and directed the CFTC to use that authority for swaps, because if swaps were not futures under the CEA, they would not need an exemption.[328] Further uncertainty remains because an exemption is always reversible by the agency.[329] The exemption is uncertain about whether the CFTC, in its reservation of the right to exert the fraud and manipulation rules of the CEA, can unilaterally enforce that right against swap participants.[330] On one hand, it is possible that the CFTC intended to maintain enforcement authority over swaps regardless of whether swaps are futures.[331] It is also possible, however, that the CFTC would only exert such jurisdiction if swaps were, in fact, found to be futures under the CEA.[332]

While the CFTC has traditionally avoided providing a precise definition of what are deemed to be futures for purposes of the CEA,[333] it has established at least four conditions it perceives as necessary for a contract to be a futures contract: "(1) a standardized contract, (2) offered to the general public, (3) secured by earnest money or margin, and (4) entered into primarily for the purpose of shifting price risk and not for transferring ownership of the actual commodities."[334] These elements were considered necessary but not sufficient for a contract to be viewed as a future. In a 1995 settlement agreement with MG Refining and Marketing, Inc. ("MGRM") and MG Futures Inc. ("MGFI"), however, the CFTC defined "'*all* the essential elements of a futures contract,' suggesting a list of *sufficient* conditions for the first time."[335] The conditions under the settlement agreement that are suf-

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tracts or settled through a clearinghouse. *See* Romano, *supra* note 30, at 56. Further, the exemption requires that a swap counterparty's creditworthiness be an essential factor of the transaction. *See id.* These qualifying conditions were intended to protect the competitiveness of futures exchanges that objected to the Swaps Exemption because swaps, being unregulated, would be cheaper and hence more competitive than futures. *See id.*; Hillary Davis, A Million A Minute: Inside the World of Securities Trading—The Men, the Women, the Money that Make the Markets Work 157 (1998) (discussing the OTC market's major encroachment into the futures industry, resulting in a precipitous fall in the volume of futures transactions due to more favorable OTC regulation).

327. Romano, *supra* note 30, at 57.

328. *See* Culp, *Functional and Institutional Interaction*, *supra* note 8, at 478.

329. *See id.*

330. *See id.*

331. *See id.* at 478-79.

332. *See id.* at 479.

333. *See id.* at 483.

334. Romano, *supra* note 30, at 25. The fourth element requires that the contract be cash settled rather than through actual physical delivery. *See id.*

335. Culp, *Functional and Institutional Interaction*, *supra* note 8, at 483 (citation omitted).

ficient to define a futures contract are: "(1) if it contains a price or pricing formula specified at the contract's inception, (2) it can be honored either by physical delivery or an offsetting transaction [cash settled] . . . , and (3) it is used either to speculate or hedge."[336]

C. *Implication for Retail Derivatives*

Because swaps are neither a future nor security, as the product expands to include retail activity, it should still remain outside of CFTC and SEC regulatory jurisdiction. The holdings and analytical frameworks of *Procter & Gamble*[337] and *Marine Bank*[338] provide valuable support for structuring the envisioned consumer swap transactions that will remain outside of United States securities regulation. The holding in *Weaver* should provide assurance to bank swap dealers that any underlying CD transaction, even if pledged to the originating bank as credit support for the swap transactions, will not be deemed a security. Further, it provides strong support that privately negotiated one-on-one swap contracts will be outside SEC regulatory jurisdiction.

The *Procter & Gamble* opinion was the first published decision by a United States court addressing the broad range of legal issues applicable to swaps and swap-related products.[339] The rulings, as they are under the laws of Ohio, are not controlling for most swap contracts which are generally governed by the laws of England or New York.[340] Legal scholars and market participants, however, regard the court's careful and thorough analysis of the "relevent [sic] legal issues [as] an unmistakable effort to establish a comprehensive framework for analyzing the regulatory and common law treatment of swaps."[341] *Procter & Gamble* supports the idea that swap transactions, depending on how they are structured, are outside of the '33 and '34 Acts. Retail derivatives should remain outside of SEC regulatory jurisdiction as long as swap dealers structure retail swaps such that: (1) their value is determined by market forces and not the entrepreneurial or managerial efforts of the swap dealer; (2) one customer's transaction is not pooled with that of another; (3) they are individually customized to each customer's objectives; and (4) they cannot be traded or sold by either the dealer or the customer without the consent of the other counterparty.

CFTC regulatory jurisdiction over the retail swaps outlined in this Note will have a chilling effect on their development. By definition,

336. *Id.*

337. Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996).

338. Marine Bank v. Weaver, 455 U.S. 551 (1982).

339. *See* McLaughlin, *supra* note 2, at 204.

340. *See* Jackson, *supra* note 98, at 207. The ISDA Master Swap Agreement provides for the selection of either New York or English law. *See* 2 Das, Global Reference, *supra* note 35, at 1374.

341. McLaughlin, *supra* note 2, at 204-05.

retail would be involved in retail swap activity, providing the CFTC with some muscle to assert regulatory authority.[342] The individualized, customized nature of each consumer transaction, however, cuts against the argument of authority. Ultimately, if consumer swaps are deemed to be a future, the exchange-trading requirement of the CEA would make such a product prohibitively unattractive to all but the most financially sophisticated and active consumer.

Privately negotiated retail derivative transactions are particularly vulnerable to assertions of CFTC jurisdiction for two reasons. First, under the classical four necessary elements definition of a futures contract,[343] consumer swaps squarely meet two of the conditions. The transactions will be offered to the general public, and will be entered into primarily, if not exclusively, for the purposes of shifting price risk (cash settled) and not for the purposes of delivering physical commodities. The potential for CFTC jurisdiction is increased under the sufficient conditions definition of a futures contract provided in the MGRM/MGFI settlement agreement, which has as a component that the contract is either used to speculate or hedge.[344] It is hard to deny that a consumer entering into a retail swap to alter the interest rate risk on their mortgage is not hedging. Additionally, it is hard to deny that an individual using a CD combined with an equity swap to transform his fixed interest payments on the CD to a return pegged to an equity index, although implicitly making an investment, could be said to be "speculating" on the stock market.

Cutting against these definitional elements that would brand retail swaps as "futures" is the great degree of customizations to individual portfolio objectives that would be required for retail derivatives to be a success. By definition, individuals have unique financial and risk objectives and requirements. Individuals that will potentially be utilizing retail swaps will have different contractual requirements, including maturity, payment dates, principal amount, payment provisions, cashflow exchanges, and credit standings.[345] The greater the customization, the more likely consumer swaps will remain outside of the CFTC's regulatory jurisdiction, as their lack of standardization will preclude their being able to be traded on an exchange.[346]

For retail swaps to develop, it is essential that they remain outside of the CEA and its exchange-trading requirement. In many instances, when a new financial product is determined to be a future, the ex-

342. *See supra* Part II.B.2.

343. *See supra* note 334 and accompanying text.

344. *See supra* notes 335-36 and accompanying text.

345. *See* Crawford & Sen, *supra* note 5, at 197-99.

346. *See* Culp, Primer on Derivatives, *supra* note 2, at 22. The standardization of futures contracts and the resulting ease of offset is what makes futures more attractive than other forms of derivatives to some derivatives users. *See id.* at 18.

change-trading requirement is "tantamount to a death sentence for trading that product in the United States."[347]

> [T]o be traded on an exchange a product must receive the prior approval of the CFTC as part of the CFTC's "contract designation" process, which includes in essence a review of the product's intrinsic merits. Under CEA § 5(7), the CFTC must conclude that the contract has an "economic purpose" and that trading in the instrument "will not be contrary to the public interest." The generality of the "economic purpose" standard and the "public interest" test necessarily convey wide agency discretion and raise difficult problems of proof for the proponents of new products. Consequently, the contract designation process is at best time-consuming—it can take years.[348]

Due to the difficulties in introducing a new futures contract, a requirement that consumer derivatives be traded on an exchange would most likely prohibit their ever reaching the consumer.

Implicit in structuring a contract to be traded on an exchange is standardization,[349] which provides price transparency as well as the ability to instantly unwind a position by purchasing or selling an offsetting contract.[350] Because they are standardized contracts, futures will be unattractive to individuals. The standardization will leave the consumer facing basis risk[351] as he attempts to determine the unique amount of futures contracts necessary to achieve his specific financial objectives. The basis risk is introduced because the consumer will have requirements that are different from those specified in the standardized futures contract in regard to contract size, payment dates, maturity, and cashflow payments.[352] Indeed, the amount of basis risk introduced by the futures contract could ultimately outweigh the intended value of the contract. It is interesting to note that corporate end-users of derivatives prefer privately negotiated derivatives relative to exchange-traded instruments by a significant margin.[353]

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347. Russo & Vinciguerra, *supra* note 172, at 470.

348. McLaughlin, *supra* note 2, at 187.

349. *See* Culp, Primer on Derivatives, *supra* note 2, at 18 (noting that the Chicago exchanges exploited the benefits of standardization in order to offer an attractive product that was different from privately negotiated derivatives).

350. *See id.* at 19-21.

351. Basis risk arises because the standardized terms of a futures contract do not match the underlying financial transaction to be hedged. This may be due to the fact that the asset whose price is to be hedged may not be exactly equal to the price of the futures contract. Also, the contract dates of the futures may not coincide with the execution, maturity, and payment dates of the underlying asset. Further, the underlying index of the future could differ from that of the underlying asset. *See* Hull, *supra* note 64, at 88-104.

352. *See id.*

353. *See* Treasury Management Ass'n, 1995 Derivatives Practices and Instruments Survey: Final Results 6 (1995). A market survey of corporate derivatives use by the Treasury Management Association, an industry association of individual treasury managers, found that 72% of the respondents used privately negotiated instruments,

Another onerous requirement of the CEA that would deter consumers from using retail swaps if they were restructured as exchange traded futures is the margin and daily settlement requirement of the exchanges.[354] To insure the integrity of the futures market, exchanges require each party to post a performance bond known as initial margin, and then, through a daily mark-to-market process, post additional margin (variation margin) in response to daily price movements.[355] The process of making or receiving daily variation margin payments, coupled with the posting of initial margin, will be inconvenient, costly, and complex for most consumers.

There is great ambiguity over the definition of a futures contract. To provide the greatest economic value, consumer swaps must avoid being labeled a future. As dealers craft and develop these products, they must emphasize their high degree of customization to deter the CFTC from seizing upon the product. Labeling these highly valuable retail transactions as futures and subjecting them to the exchange trading requirement will greatly reduce, if not eliminate, their value to consumers. In addition to having to comply with the complex and costly margin requirements, individuals will not be able to structure transactions to exactly match their portfolio objectives. Part V discusses why further regulation of retail derivatives is unnecessary despite the presence of a product regulator such as the SEC or CFTC.

V. INCREASED REGULATION FOR RETAIL SWAPS IS UNNECESSARY

The SEC and CFTC do not have regulatory authority over the current institutional swap market, nor should their authority apply when swaps become available to the public. Once these product regulators observe retail activity in privately negotiated derivatives, however, the inevitable first response is to clamor for increased regulatory supervision through a derivatives policeman. Increased regulation is unwarranted. The structure of retail derivatives and the nature of individual investment decisions provide sufficient incentives to deter fraud and

whereas only 17% used exchange-traded products. *See id.* The survey respondents reported that their preference for OTC instruments was due to their ability to selectively match their exposure. *See id.* at 2, 6.

354. *See* 2 Das, Global Reference, *supra* note 35, at 1061-1114. Das provides a thorough analysis of the complications of using futures contracts rather than a tailored privately negotiated contract to hedge financial exposures. These include among other things calculating the hedge, re-balancing the hedge in response to market moves, managing the financing costs of the hedge ("tail risk"), maturity and payment date mismatches, basis risk, and margin costs. *See id.* Das states that corporations usually have preferred to use privately negotiated derivatives over futures contracts. *See id.* at 1079. Corporations, in general, enter into privately negotiated derivatives with financial institutions. The financial institutions that are maintaining a portfolio of transactions and hedge their exposure at the margin, in turn hedge their financial risk with futures contract in addition to other financial instruments. *See id.*

355. *See* Kapner & Marshall, *supra* note 11, at 180.

other manipulative sales practices. Increased regulation to police consumer swaps will only lead to increased cost, and would perhaps ultimately drive the activity offshore.

A. *A Cost-Benefit Framework for Financial Regulation*

It is constructive to address the purposes of financial regulation and under what circumstances increased regulation is warranted. According to Roger Andersen, Deputy Assistant Secretary of the United States Department of the Treasury, "[r]egulation can impose costs of compliance, and, if those costs are not compensated for by the benefits of compliance, then those costs can get passed on to Treasury and the taxpayers."[356] Wendy Gramm, former CFTC chairman, identifies three reasons for regulation of financial markets: "(1) providing for adequate levels of customer and investor protection; (2) maintaining market or price integrity; [and] (3) protecting the financial integrity of the system."[357] In particular, government regulation is required only when a market failure exists that prevents the industry from working out a market-based or contractual solution to the problem.[358] The former chairman states that the current regulatory structure is sufficient for institutional activity because "both common law and statute allow arm's-length contracts to be voided under certain instances including willful deception, the failure to disclose material information, and the possession of information that would give one party an 'unconscionable' bargaining advantage."[359] These remedies will also be available for retail swap participants.

B. *Structure Inherently Protects Against Fraud*

Because privately negotiated derivatives, whether institutional or retail, are bi-lateral contracts, "[d]ealers . . . must regularly demonstrate their integrity, reputations, and ability to honor long-term commitments."[360] Each counterparty assumes the counterparty risk of the other.[361] Counterparty risk consists of two components: credit risk (default risk) and the possibility that a counterparty will renege on their contract.[362]

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356. Roger L. Anderson, *The Treasury Department's Role in Regulating the Derivatives Marketplace,* 66 Fordham L. Rev. 775, 778 (1997).

357. Wendy Lee Gramm & Gerald D. Gay, *Ready-Fire-Aim: An Antidote to Derivative Regulation by Anecdote, in* Derivatives Handbook: Risk Management and Control, *supra* note 8, at 433, 434.

358. *See id.* at 443.

359. *Id.* at 435.

360. *See* Culp, Primer on Derivatives, *supra* note 2, at 82.

361. *See* Crawford & Sen, *supra* note 5, at 199.

362. *See* Romano, *supra* note 30, at 51-53. The credit risk of futures contacts is very minute due to the clearinghouse mechanism (margin system) and is not that of any underlying counterparty, but the exchange itself. *See* Gibson, *supra* note 2, at 542. Indeed, futures exchanges were essentially thought to be without credit risk until the

Because counterparty risk is inherent in the swap structure, a dealer must have several strengths to be competitive in offering derivatives: "a relatively strong credit standing, large relative capitalization, good access to information about a variety of end-users, and relatively low costs of managing the residual risks of an unmatched portfolio of customers" entering into privately negotiated derivatives.[363] These characteristics preclude the possibility of retail participants transacting among themselves. They do not have the credit rating, capitalization, or the ability to match and offset transactions against each other. The logical candidates to be involved are those already active in financial activity—commercial and investment banks and non-bank financial corporations such as insurance and trading affiliates.[364]

Retail swap transactions will necessarily involve an institution such as a commercial bank that is already involved in financial activity.[365] It is telling that even in the institutional derivatives market, the structure of having two institutional counterparties directly enter into swap contracts with each other was quickly abandoned.[366] Instead, institutional end-users, rather than contracting directly with each other, contract with a financial corporation, providing end-users with a counterparty of acceptable credit risk and relief from the responsibility of making complex credit evaluations of other institutional participants.[367] Retail end-users will seek out financial swap counterparties as well. In fact, the incentive for individuals, rather than institutions, to transact with counterparties with impeccable credit standing is even stronger, because their own money is at stake.

An untarnished reputation is now essential for long run success as a derivatives dealer: "Just like Caesar's wife, market participants in the derivatives industry must be above reproach."[368] There is no doubt that Bankers Trust's position as a premiere derivatives dealer crumbled in response to the publicity alleging that Bankers Trust had engaged in sales practices resulting in significant losses to their

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trading activity Nick Leeson on behalf of Barings Bank (Singapore office) on the Singapore Monetary Exchange ("SIMEX") resulted in significant losses and fears for the exchange's solvency. *See* Anatoli Kuprianov, *Derivatives Debacles: Case Studies of Large Losses in Derivatives Markets*, *in* Derivatives Handbook: Risk Management and Control, *supra* note 8, at 605, 617-19.

363. Culp, Primer on Derivatives, *supra* note 2, at 27.

364. *See id.*

365. *See* Crawford & Sen, *supra* note 5, at 197-98 (detailing several examples of derivatives use by individuals in the future that all involve the individual transacting with a financial institution and not another individual).

366. *See* Das, Swap Financing, *supra* note 14, at 34-35; *see also* 1 Das, Global Reference, *supra* note 35, at 26 ("As the variety of end-users on both sides of the market increased, potential couterparties grew increasingly reluctant to accept the credit risk involved.").

367. *See* 1 Das, Global Reference, *supra* note 35, at 26.

368. Bradley D. Belt & George P. Stamas, *The Intangibles: Political, Regulatory and Reputational Risk*, *in* An Introduction to VAR 3, 28 (Rod Beckström & Alyce Campbell eds., 1995) [hereinafter Belt & Stamas, *Introduction to VAR*].

counterparties such as Gibson Greetings and Proctor & Gamble.[369] As a consequence, swap dealers are now more aware than ever of the importance of signaling their integrity and strong credit rating to the market.[370] For instance, J.P. Morgan now provides to the public its own internally developed derivatives risk management technology, Riskmetrics.[371] J.P. Morgan released its method for calculating market risk to increase transparency in the markets and to establish a common standard for measuring risk.[372] Another example is the Derivatives Policy Group's publishing in March 1995 of *Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firms Affiliates to Promote Confidence and Stability in Financial Markets*, which is the agreement of six investment banks to voluntarily provide the CFTC and SEC reports of their derivatives operations.[373] And many banks and brokerage houses have established AAA subsidiaries for the sole purpose of derivatives dealing.[374] The AAA sub-

369. *See* Loomis, *supra* note 15, at 59-68. Loomis provides a detailed analysis of the reputational harm and resulting business loss suffered by Bankers Trust as a result of the alleged losses by Procter & Gamble and Gibson Greetings Cards. *See id.*

370. *See* Cohen, *supra* note 43, at 2028-29.

371. *See* Michael R. Sesit, *Morgan Unveils the Way It Measures Market Risk*, Wall St. J., Oct 11, 1994, at C1. Sesit observes J.P. Morgan's release of proprietary information as an aggressive effort to establish the standard by which financial institutions and corporations measure risk. *See id.*

372. *See id.*

373. Derivatives Policy Group, Framework for Voluntary Oversight: A Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firms Affiliates to Promote Confidence and Stability in Financial Markets (Mar. 1995). The Derivatives Policy Group consists of six investment banks: CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers. The group was established at the recommendation of Arthur Levitt, Chairman of the SEC. *See id.* at 1. The group established management, reporting, capital, and counterparty regulations. The firms voluntarily agreed to send compliance reports of these requirements to the SEC and CFTC. *See id.* at 2-3.

It has been suggested that the best approach to the regulatory conundrum of derivatives would be an industry wide voluntary implementation of best practices. *See* Thomas A. Russo, *Self Regulation*, Futures Industry, Feb./Mar., 1999, at 16, 16. "A more appropriate approach to financial market 'regulation' is not regulation in the traditional sense; rather, a comprehensive, voluntary initiative spanning national boundaries and outdated distinctions among financial products and market participants presents the best answer to the regulatory quandary that has defied legal resolution." *Id.*

374. *See* 2 Das, Global Reference, *supra* note 35, at 1152. Credit ratings for the AAA subsidiaries are analogous to bond ratings. For a description of Moody's and Standard and Poor's bond ratings see Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 664-65 (1996). The capital adequacy of a AAA derivatives subsidiary also know as a Special Purpose Derivatives Vehicle (SPDV) is the essential element that provides the subsidiary with a rating above that of its parent. *See* 2 Das, Global Reference, *supra* note 35, at 1154. In addition, Moody's and Standard and Poor's consider the proposed portfolio credit quality, counterparty credit risk, managerial and operating guidelines, and controls on the parent-subsidiary relationship. *See id.* at 1153. The capital level required to be maintained by the AAA is calculated by use of a risk model that estimates the effects of default and market risk on the AAA subsidiary's portfolio. *See id.* at 1154.

sidiary allows those dealers engaged in derivatives with less than a AAA credit rating to establish a separate legal entity that will have a AAA credit rating for purposes of its derivative business.[375] The AAA is granted by the rating agencies only after the subsidiaries' independence from the parent is established along with a showing of high capitalization.[376] The incentives to provide reputational signals to attract derivatives end-users will be just as prevalent for retail swaps due to the omnipresent existence of couterparty risk.

C. *Increased Regulation Will Drive Retail Activity Offshore*

As Susan Phillips, a member of the Board of Governors of the Federal Reserve System, cautions, "The challenges of supervision in a rapidly changing financial and technological environment actually are compounded by global integration in the market place. To the extent that regulation in one country is deemed too restrictive, firms can avoid it by simply booking business in another country."[377] The advent of the Internet has significantly facilitated consumer access to offshore markets.[378] United States regulators need to tread cautiously in the arena of retail derivatives to prevent the product's development outside of the United States. Unfavorable regulation in the United States has played a substantial role in moving profitable financial activities offshore, including investments in Eurobonds,[379] Brent oil contracts,[380] and commodity swaps.[381]

As discussed earlier, swaps came to the attention of the CFTC in 1987 primarily due to commodity swap activity.[382] That year, the CFTC published an Advance Notice of Proposed Rulemaking, announcing its intention to assert jurisdiction "over virtually all hybrid

375. *See* 2 Das, Global Reference, *supra* note 35, at 1152.

376. *See id.*

377. Susan M. Phillips, Keynote Address at the Derivatives and Risk Management Symposium at Fordham University School of Law (1997), *reprinted in* 66 Fordham L. Rev. 767, 773 (1997).

378. Prior to the development of financial transactions on the Internet, Merton Miller noted that as derivatives markets operate telephonically, electronically, and by computer, they are "extremely sensitive to political and financial developments around the world and around the clock." McLauglin, *supra* note 78, at 195.

379. A eurobond is a bond that is sold by an international syndicate of underwriters to foreign investors. The underwriters are located primarily in London, although eurobonds may be sold throughout the world. *See* Brealey & Myers, *supra* note 374, at 682.

380. *See* Transnor (Bermuda) Ltd. v. BP North America Petroleum, 738 F. Supp. 1472, 1475 (S.D.N.Y. 1990) (defining Brent oil as "a blend of oils produced in various fields in the North Sea and delivered through pipelines for loading onto cargo ships at Sullem Voe in the Shetland Islands."). One of the issues in *Transnor* was whether or not the Brent oil market was an international or primarily United States market. *See id.* The court held the Brent market to be a United States market. *See id.* at 1475-76.

381. *See supra* note 11.

382. *See supra* notes 109-13 and accompanying text.

instruments, with only limited exclusions or exemptions. . . ."[383] Hybrids were defined as financial instruments that, although styled as a security, had payment features economically equivalent to those of commodity futures or options.[384] The CFTC began investigative and enforcement proceedings against the institutions that were beginning to be involved in commodity swaps.[385] The CFTC's actions halted the development of commodity swaps in the United States, forcing United States institutions to shift their activity to London and other financial centers.[386] The swap industry's reaction to this CFTC action was dramatic: "[t]he domestic commodity swap business ceased to exist as all deals moved overseas and a 'firestorm of criticism' for the Commission's actions ensued."[387]

One scholar asserts that the slower currency market growth rate in recent years in the United States relative to the United Kingdom could be caused by the legal uncertainty surrounding the interpretation of the Treasury Amendment's definitions of "in foreign currency" and "board of trade."[388] The United Kingdom's currency market has grown at a rate of sixty percent, while the United States grew at an average rate of forty-six percent.[389] Another possible reason for the slower growth rate in the United States is market participants' fear that foreign currency options, because they were transactions "involving" and not "in" foreign exchange, were not covered by the Treasury Amendment, and were thus unenforceable.[390] Further, ambiguity remains over the definition of "board of trade" in the Treasury Amendment.[391] A court within the Eastern District of New York construed the term to include not only organized exchanges designated as commodity markets by the CFTC, but "any informal association of persons engaged in the business of buying and selling" foreign currency.[392] Thus, CFTC jurisdiction could be interpreted to extend to all currency transactions, including those entered into by two institutions.[393] Although the Supreme Court's decision in *Dunn* makes

383. McLaughlin, *supra* note 2, at 139.
384. *See id.* at 139-40.
385. *See id.* at 140.
386. *See id.*
387. Tormey, *supra* note 125, at 2360.
388. *See id.* at 2342, 2352-56, 2359 n.300.
389. *See id.*
390. *See id.* at 2319.
391. *See id.* at 2353.
392. Commodity Futures Trading Comm'n v. Standard Forex, Inc., No. CV93-0088, 1993 WL 809966, at *7 (E.D.N.Y. Aug. 9, 1993).
393. *See* Tormey, *supra* note 125, at 2320-21. "[T]he meaning of the term 'board of trade' has become hopelessly tangled in the controversy over the meaning of the so-called Treasury Amendment." Harris, *supra* note 203, at 1171. A narrow reading of the term would limit the exchange trading requirement of organized exchanges. *See id.* at 1172. A broad reading, however, where potentially transactions between two individuals could be included, "would render the Treasury Amendment purposeless, for virtually no transaction would escape CFTC jurisdiction." *Id.*

clear that the Treasury Amendment applies to foreign currency options,[394] it is plausible that the legal uncertainty surrounding currency options in the past, coupled with the remaining uncertainty regarding the definition of the board of trade, has curtailed the growth rate of United States currency markets relative to the United Kingdom.[395]

In 1990, the 15-day Brent oil contacts moved offshore in response the Southern District of New York's holding in *Transnor (Bermuda) Ltd. v. BP North American Petroleum*.[396] The court found that the contracts were futures, and therefore were regulated under the CEA.[397] The decision led many major oil companies to relocate their oil trading operations overseas.[398] Although the CFTC tried to counter the offshore migration by issuing a statutory interpretation that stated the contracts were not subject to the CEA regulation as they fell within the CEA's "cash forward exclusion,"[399] the ruling came too late. The oil companies "never fully returned" to the United States.[400]

The development of the Eurobond (dollar denominated bonds issued in Europe) market and the resulting outflow of capital from the United States, is another example of a financial product migration due to government-created costs.[401] In the 1960s, the United States required foreign investors receiving interest from bonds purchased in the United States to pay a thirty percent withholding tax.[402] The imposition of this tax led to the establishment of London, not New York, as the primary market for United States dollar bonds that are not sold to United States citizens.[403] Even with the subsequent repeal of the withholding tax, the market has remained overseas.[404]

Banking regulators also introduced financial regulation that led to profitable financial activity moving offshore.[405] Due to the Federal Reserve's Regulation Q, which capped the rate that United States commercial banks could pay on time deposits pay for funds raised through the acceptance of consumer time deposits, "much of the deposit-taking activity of U.S. money-center banks moved offshore."[406]

The above examples of the movement offshore of United States financial activity in response to government regulation indicate that

394. *See* Dunn v. Commodities Futures Trading Comm'n, 117 S. Ct. 913, 920-21 (1997).
395. *See* Tormey, *supra* note 125, at 2359 n.300.
396. 738 F. Supp. 1472 (S.D.N.Y. 1990).
397. *See id.* at 1493.
398. *See* McLaughlin, *supra* note 2, at 195.
399. *See id.*
400. *Id.*
401. *See* Belt & Stamas, *Introduction to VAR*, *supra* note 368, at 6 n.3.
402. *See id.*
403. *See id.*
404. *See id.*
405. *See* McLaughlin, *supra* note 2, at 34-35.
406. *See id.* at 35.

regulators must use caution in regulating new financial instruments. Historically, even when the United States regulators retracted offensive regulation, in many cases the activity never fully returned.[407] Congress should take especially careful note of the example provided by Japan. Japan's current restrictive derivatives regulation has led much of the activity to move offshore.[408] The flow of transactions to offshore dealers will ironically have the result of decreasing United States regulatory oversight of the derivatives market.[409]

D. *Retail Swaps Involve Asset Class Decisions*

The types of swaps that consumers will be transacting will largely involve an alteration of their portfolios between various asset classes. Individuals will have the ability to swap among equity returns, fixed income return, real estate returns, commodities returns, and so forth. What is relevant to consumers in their decision-making process is information about past performances of asset classes, not individual share information.[410]

Subjecting consumer derivatives to a regulator such as the SEC, which mandates disclosure of material firm specific information concerning the derivatives dealer, would only unnecessarily increase costs—it would provide information that would be of marginal value (if not irrelevant) to the consumer.[411] Under historic disclosure rules, entities are primarily required to provide firm-specific information.[412] A corporation is required to provide specific price and dividend information about its own stock.[413] Reports concerning the overall performance of common stocks, including aggregate risk and return levels, are not required.[414] Broad asset class information, such as predictions of future risks and returns, are not traditionally part of required disclosures.[415]

Individuals are concerned with future returns; firm-specific information is only one part of the picture for those individuals who hold shares in a mutual fund or other broad asset class.[416] With only firm-specific information, individuals are left to fend for themselves as to general performance predictions over the long term of specific asset

407. *See supra* notes 377-406 and accompanying text.
408. *See* Singher, *supra* note 174, at 1472 n.549.
409. *See* Wendy Lee Gramm, *In Defense of Derivatives*, Wall St. J., Sept. 8, 1993, at A12.
410. *See generally* Hu, *Illiteracy and Intervention*, *supra* note 193, at 2324-25 (discussing how current securities disclosure rules that emphasize issuer-specific information has led to asset-class "illiteracy").
411. *See id.* at 2321-23.
412. *See id.* at 2322.
413. *See id.* at 2323.
414. *See id.*
415. *See id.*
416. *See id.* at 2359-60.

classes.[417] Long-term analysis and projection are more likely to be informative of future returns than individual, firm-specific information.[418]

The SEC prevented firms from making projections in their disclosure statements, as they were concerned that the projections might potentially mislead unsophisticated investors.[419] The SEC regarded the projections skeptically, as they were not hard facts, but simply based on probability, and "paradoxically, investors were just as competent to make projections."[420] In 1973, however, the SEC announced a change in its position concerning the disclosure of probabilistic projections.[421] As of 1978, the SEC has encouraged the inclusion of registrant's projections in their SEC filings.[422] Additionally, the SEC issued Rule 175 under the '33 Act.[423] This rule establishes a limited safe harbor for projections in SEC filings that are made with a "reasonable basis" and in "good faith."[424] The Private Securities Litigation Reform Act of 1995 extended the statutory safe harbor to those companies that are subject to the continuous reporting requirements of the '34 Act.[425] Even as the SEC has begun to require future-oriented information, the safe harbors for such information under Rule 175 and under the Private Securities Litigation Reform Act of 1995 still "focus on protecting predictions about the entity, not about the trading price of the entity's security."[426]

Similar disclosure rules exist for mutual funds, despite the fact that an investment in the fund represents an interest in all of the fund's assets.[427] Nevertheless, the mandatory disclosure system for mutual funds places greater importance on firm-specific information and "little by way of probabilistic asset class information is required."[428]

In the investment management process, asset class allocation decisions are ultimately more important than market timing or individual security selection in generating returns.[429] In an analysis of ninety-one large United States pension plans over the years 1974-1983, "ninety-four percent of the variation in total plan return was ex-

417. *See id.* at 2360.
418. *See id.*
419. *See id.* at 2329.
420. *Id.*
421. *See* Cox, *supra* note 114, at 71.
422. *See id.*
423. 17 C.F.R. § 230.175(c) (1996) (definition of "forward-looking statement" for purposes of Rule 175 safe harbor).
424. *See id.*
425. 15 U.S.C. § 77z-2 (Supp. II 1996) (definition of "forward-looking statement" for purposes of the Act's safe harbor).
426. Hu, *Illiteracy and Intervention*, *supra* note 193, at 2329.
427. *See id.* at 2358-59.
428. *Id.* at 2359.
429. *See id.* at 2362.

plained solely by long-term allocation among asset classes . . . ."[430] Indeed, "[s]ecurity selection, the choice of particular stocks and bonds, was of only marginal relevance."[431]

Increased responsibility is being placed on consumers to make asset allocation decisions for at least two reasons. The first is the "dramatic shift in the nature of pensions over the past two decades, from defined benefit . . . plans to defined contribution . . . plans . . . ."[432] Unlike a defined benefit plan, under a defined contribution plan an individual makes his own financial decisions.[433] The second reason behind increased individual financial responsibility is Social Security. As one commentator has shrewdly observed, "[a]ccording to a recent poll, more young people believe in the existence of UFO's than in the continuing ability of Social Security to provide for them in their old age."[434] Thus, individuals will be required to provide for retirement themselves through pension plans and investment management.

With the advent of retail derivatives, consumers will gain greater access to vital financial information due to swap dealers' self-interest. As derivatives dealers compete for business, they will have the incentive and capability to provide consumers with databases of information on past asset class performance. Dealers will have to take care, however, to offer the information in such a way that a later disgruntled consumer can not claim reliance and sue the dealer should the actual return fall short of past return.

As the swap market evolved, both the headline-grabbing losses of 1994[435] and the complexity felt to be behind the product induced many, including Congress, to call for increased derivatives regulation through suitability standards.[436] The concept of suitability emerged in

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430. *Id.*

431. *Id.*

432. *Id.* at 2365.

433. *See id.* at 2366.

434. *Id.*

435. In 1994, it was reported that losses by users of derivatives reached $10 billion. *See* Adams & Runkle, *supra* note 19, at 1. In discussions of derivative losses, the aggregate reports generally do not distinguish between whether the derivatives involved were swaps, futures, or securities with embedded derivatives. Among the

> most notable publicly reported or acknowledged losses of users of derivatives include: Gibson Greetings ($23 million); Procter & Gamble ($157 million); MG Corp., the [United States] subsidiary of Germany's Metallgesellschaft AG ($1.5 billion); Dell Computer; Atlantic Richfield Co. ($22 million); Marion Merrell Dow ($11 to $14 million); Mead Corp. ($7.4 million); Paramount Communications ($20 million); Caterpillar's financial services unit ($13.2 million); City Colleges of Chicago ($40 million); Odessa College ($10 to $20 million); Escambia County, Florida ($19 million); Wisconsin's investment fund ($95 million); and Orange County, California ($2 billion).

Id. at 1-2.

436. *See* Gibson, *supra* note 2, at 529-30.

1938 through the National Association of Securities Dealers ("NASD"), which requires the following from its members:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[437]

The New York Stock Exchange's "know your customer" rule, established in 1960, requires its members to "use due diligence to learn the essential facts relative to every customer [and] every order."[438] It is interesting to note that although the NASD and the major national exchanges have suitability rules, the SEC does not.[439] The CFTC also does not have a suitability standard, and has stated that the "antifraud provisions contained in the CEA do not impose a legal suitability obligation on futures professionals."[440] In 1993, the Office of the Comptroller of the Currency ("OCC") issued OCC Banking Circular 277, *Risk Management of Financial Derivatives*.[441] Although the circular required banks to determine whether a proposed derivative transaction is appropriate for a customer, the OCC, in an interpretive release, stated that it was not a suitability standard.[442] The guidelines were not issued to protect the customer, but rather to ensure the safety and soundness of the banks' derivatives business and ultimately, the banks, themselves.[443]

Adopting suitability standards to protect consumers entering into retail swaps is unnecessary. First, suitability is generally undefinable, and, "[l]ike beauty . . . is often in the eye of the beholder."[444] Second, suitability requirements would encroach upon the privacy of customers' financial affairs.[445] Third, the cost of providing all of the information necessary for a derivatives dealer to determine if a swap is suitable for an individual might increase costs to once again make the

437. Walter C. Greenough, *The Limits of the Suitability Doctrine in Commodity Futures Trading*, 47 Bus. Law. 991, 993-94 (1992) (quoting NASD Rules of Capital Fair Practice, art. III, § 2 (a), NASD Manual (CCH) ¶ 2152, at 2051).

438. *Id.* at 994 (alteration in original).

439. Jennifer A. Frederick, Note, *Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market*, 64 Fordham L. Rev. 97, 108 (1995).

440. *Id.* at 103.

441. *See* Belt & Stamas, *Introduction to VAR*, *supra* note 368, at 16 n.29.

442. *See* Comptroller of the Currency, Risk Management of Financial Derivatives (1993); Gibson, *supra* note 2, at 567-68.

443. *See id.* at 569.

444. Greenough, *supra* note 437, at 993; *see also id.* at 1006 ("Is someone with a large net worth and a proclivity for gambling less 'suitable' than someone who is less wealthy but more controlled?").

445. *See id.* at 1007-08.

product prohibitive at the retail level.[446] Fourth, a suitability doctrine would encourage unwarranted litigation: "Unscrupulous customers would try to recover their [derivatives] losses by claiming that they never should have been allowed to trade."[447] Ultimately, because a suitability doctrine imposes a duty on a dealer to refuse to transact certain trades, it places the customer in a no-lose situation:

> If the broker refuses to execute a trade that turns out to have been profitable, the customer will point to the profitability of the trade as evidence of its suitability and sue the broker for failing to follow her orders. On the other hand, if the broker executes an order that results in a loss, the customer will claim that the broker should have rejected the order because of its obvious (in hindsight) unsuitability.[448]

The judicial system protects consumers by providing an adequate forum for consumers to seek redress for any "losses resulting from fraudulent sales practices."[449] Legal action and/or the threat of legal action serve as a means of both preventing and deterring dealer misconduct.[450] And, as stated by Federal Reserve Chairman Alan Greenspan, the most powerful incentive a swap dealer has to avoid fraudulent practices is the "fear of loss of the dealer's good reputation, without which it cannot compete effectively."[451]

E. *A Fiduciary Duty to Use Derivatives*

A recent holding by an Indiana appellate court suggests that trustees "may now have a duty to understand uses of derivatives to achieve the most appropriate mix of risk and return for their beneficiaries, and to use derivatives when they offer the best means of achieving that mix."[452] In *Brane v. Roth*,[453] directors of a rural grain elevator cooperative ("Co-op") were sued by their shareholders for failing to effectively hedge the Co-op's exposure to grain prices.[454] Ninety percent of the Co-op's business was buying and selling grain.[455] The profits of the Co-op had fallen continuously from 1977.[456] After a substantial

446. *See id.* (detailing that the costs of monitoring the consumer's financial and emotional suitability would be passed onto the consumer, regardless of whether he wanted the service).

447. *Id.* at 1008.

448. *Id.*

449. Gibson, *supra* note 2, at 581.

450. *See id.*

451. *Id.* at 581 n.346.

452. George Crawford, *A Fiduciary Duty to Use Derivatives?*, 1 Stan. J. L. Bus. & Fin., 307, 307 (1995).

453. Brane v. Roth, 590 N.E.2d 587 (Ind. Ct. App. 1992). The derivative instruments involved in *Brane* are exchange-traded futures, and not privately negotiated derivatives. *See supra* notes 41-84 and accompanying text.

454. *See Brane*, 590 N.E.2d at 589.

455. *See id.*

456. *See id.*

loss in 1979, the Co-op's accountant recommended hedging in the grain futures market.[457]

The Co-op's directors approved the accountant's recommendation and authorized an inexperienced manager to hedge for the Co-op.[458] Of the Co-op's $7,300,000 in grain sales, only $20,050 was hedged.[459] The lower court held and the Court of Appeals affirmed, that the corporate directors were liable for the losses, because the losses stemmed from the inadequate hedging program.[460] The court ruled that the directors breached their duty by: (1) retaining an inexperienced manager; (2) failing to reasonably supervise the manager; (3) failing to become aware of the essentials of hedging to be able to monitor the activity; and (4) being grossly inattentive.[461]

Some involved in the industry interpret *Brane* as going even beyond suggesting that trustees may have a duty to understand derivatives and incorporate them when appropriate in managing their beneficiaries' portfolios.[462] For example, ISDA's outside counsel states that "the Indiana Court of Appeals held that the failure to hedge constituted a breach of the fiduciary duty of care" owed by the Co-op's directors to its shareholders.[463] Further, a former CFTC Chairman, Philip McBride Johnson, questions whether "we are moving to a time when failing to hedge may become a fundamental management flaw and if there might eventually evolve a concept of per se (or automatic) liability whenever unwanted risks that can be avoided are not properly hedged."[464]

CONCLUSION

"Derivatives are here to stay."[465] At the institutional level, derivatives markets exist for all major currencies and for a significant portion of the more domestic currencies. Swaps exist not only for currency, interest rate, equity, and commodity indexes, but for such

457. *See id.*
458. *See id.*
459. *See id.*
460. *See id.*
461. *See id.* at 589-91.
462. *See* McLaughlin, *supra* note 2, at 469-70.
463. *See id.* at 470 (quoting Daniel P. Cunningham, *Do Corporations Have a Duty to Hedge? Brane v. Roth and In re Compaq*, *in* Smithson et al., Managing Financial Risk 67, 67-70 (1995)).
464. Hu, *Hedging Expectations*, *supra* note 16, at 1016 & n.143. *But see* McLaughlin, *supra* note 2, at 470 (criticizing a broad interpretation of *Brane*'s holding). McLauglin disagrees that the *Brane* holding supports a proposition that managers and directors, or even trustees have a duty to hedge. He suggests that the case only implies that: (1) management must understand the fundamentals of a hedging product and for what use it is intended before making a decision to use that product; and (2) management must oversee the actual implementation of the hedging product to ensure that it is being used as intended. *See id.* at 472.
465. *See* Crawford & Sen, *supra* note 5, at 195.

indexes as far-ranging as earthquakes and hurricanes (disaster derivatives), Gross National Product (macro swaps), and art.[466] The next frontier is the consumer. Swaps are simply too powerful a risk management tool to be denied to consumers, now that cost is no longer a prohibitive factor.

As swaps enter the retail phase of development, no further regulation is necessary. Counterparty risk, inherent in swap transactions, will mandate that retail participants do not enter into transactions directly with each other. Consumers, acting in their own self-interest, will rationally transact with financial institutions that have the greatest capital and strongest credit rating. Further, while financial theorists debate about whether corporations should engage in derivative transactions to hedge their financial risks because investors can simply diversify away unwanted risks, it is undisputed in financial theory that individuals should hedge.[467] Increased regulation of swaps would increase costs, thus either greatly restricting or prohibiting desired risk-reducing, economic-maximizing behavior. Regulation must not interfere with the inevitable trend of widespread use of retail swap activity through the Internet and elsewhere. Indeed, it is not difficult to envision a world where family financial managers, who have the responsibility of providing the necessary funds to send their children to college, will have a fiduciary duty to use derivatives to manage the risk of their portfolios. Have you hedged today?

466. *See* 2 Das, Global Reverence, *supra* note 35, at 1444-45. An interesting idea for a macro swap is discussed by John F. Marshall, *Derivatives and Risk Management*, *in* The New Tool Set: Assessing Innovations in Banking 1995, at 79, 83-84. He suggests that the use of macro swaps could ultimately aid in balancing the United States budget. The Treasury could enter into Gross National Product linked swaps to immunize revenues or even enhance revenues during a recession. *See id.* at 84.

467. In fact, individual investor hedging is the base foundation for the modern financial theory, the Capital Asset Pricing Model. *See* Brealey & Meyers, *supra* note 374, at 153-65.