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Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers

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I. INTRODUCTION

In recent years, many companies and municipalities have incurred substantial losses from trading in the over-the-counter ("OTC") derivatives market.[1] In many instances, those investors who incurred such losses asserted that the derivatives dealers failed to disclose the risks associated with the derivatives instruments they purchased.[2]

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1. *See* Andrew Bary, *Peter Pan Portfolio: Orange County Bet That Interest Rates Would Stay Low Forever*, BARRONS, Dec. 5, 1994, at 17 (explaining that Orange County lost $1.5 billion from derivatives losses due to the failure of the Treasurer to adjust the value of securities based on interest rates); Nicholas Bray & Lawrence Ingrassia, *Losses at Barings Grow to $1.24 Billion; British Authorities Begin Sale of Assets*, WALL ST. J., Feb. 28, 1995, at A3 (reporting the sale of assets of Barings after a $1.24 billion loss caused by unauthorized futures and options traders); Jonathan Friedland, *Bankers Trust to Cancel Two Contracts About Derivatives with Federal Paper*, WALL ST. J., Dec. 20, 1994, at A2 (reporting that $19 million loss incurred by Federal Paper for two derivatives contracts would be canceled by Bankers Trust); Brett D. Fromson, *Air Products Raises Estimate on Losses Due to Derivatives: Firm Expects to Lose $111.3 Million Pretax*, WASH. POST, May 17, 1994, at D5 (reporting that Air Products and Chemical, Inc. took an estimated $111.3 million derivatives loss on a pretax basis); Laura Jereski, *Wisconsin Investment Board Discloses Second Big Derivatives Trading Loss*, WALL ST. J., May 16, 1995, at C19 (reporting that the state of Wisconsin suffered its second derivatives loss of $100 million following its first derivatives loss of $95 million); G. Bruce Knecht, *Pied Piper: Minneapolis Investors Are Hurt by Local Firm They Knew as Cautious*, WALL ST. J., Aug. 26, 1994, at A1 (reporting that institutional funds managed by Piper Jaffray experienced losses that could exceed $700 million); Steven Lipin, *Gibson Sues Bankers Trust Over Derivatives*, ASIAN WALL ST. J., Sept. 14, 1994, at 13 (reporting that Gibson Greetings, Inc. had brought legal action against Bankers Trust for a $20 million derivatives loss); Matt Murray & Gary Putka, *Mellon Bank Plans a Charge of $130 Million*, WALL ST. J., Nov. 29, 1994, at A2 (reporting that Mellon Bank would take a $130 million charge to compensate institutional customers for losses in securities that included some volatile derivatives); Gabriella Stern & Steven Lipin, *Procter & Gamble to Take a Charge to Close Out Two Interest-Rate Swaps*, WALL ST. J., Apr. 13, 1994, at A3 (reporting that Procter & Gamble planned to take a pretax charge of $157 million for losses incurred from leveraged swap transactions).

2. *See* John Connor, *Finance Officers Say Brokers Misled Governments About Risk of Derivatives*, WALL ST. J., Jan. 9, 1995, at A9B (reporting that government finance

Several investors filed lawsuits against derivatives dealers to recover losses from trading in derivatives.[3] In some cases, the investors assert that their dealers served them in a fiduciary capacity and, therefore, had a duty to ensure that the derivatives transactions were suitable for them.[4] Dealers maintain that because derivatives transactions are arm's length transactions, investors must protect their own financial interests.[5] Dealers argue that the imposition of suitability obligations in the derivatives market create additional duties and responsibilities that are vague, overly burdensome and costly.[6]

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officers testified before Congress that they were misled by securities professionals about the risk associated with derivatives instruments); G. Bruce Knecht, *The Lawyers' Turn, Derivatives Are Going Through Crucial Test: A Wave of Lawsuits*, WALL ST. J., Oct. 28, 1994, at 1 (reporting that investors in Piper Jaffray's Government Institutional Portfolio filed a federal lawsuit against Piper Jaffray, alleging that the company provided a false and misleading picture of the risk involved in a mutual fund heavily comprised of mortgage-based derivatives); Dean Tomasula, *Swaps Suit Against BT Could Set Precedent Gibson Greetings Says Banks, Broker Unit Failed to Disclose Risk Series*, AM. BANKER, Sept. 14, 1994, at 30.

3. *See* Cris Carmody, *Courtroom Fallout from Derivatives Disasters Is Touching the Securities Business*, BOND BUYER, Dec. 13, 1994, at 3; Knecht, *supra* note 2, at 1; Steven Lipin, *Bankers Trust Sued On Derivatives*, WALL ST. J., Sept. 13, 1994, at C1 (reporting that Gibson Greetings filed suit against Bankers Trust alleging that Bankers did not disclose the risks of financial derivatives products it sold to Gibson); Stephen J. Sansweet & Rhonda L. Rundle, *Orange County Is to Sue Some Firms; It Defaults on $110 Million Bond Issue*, WALL ST. J., Dec. 9, 1994, at A3.

4. *See* State v. Morgan Stanley & Co., 459 S.E.2d 906, 910 (W. Va. 1995) (alleging that a fiduciary relationship existed between the State of West Virginia and Morgan Stanley, one of six derivatives dealers from which the state purchased derivatives that ultimately resulted in $280 million loss); *see also* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1289 (S.D. Ohio 1996) (alleging that Bankers Trust acted as a commodity trading adviser with Procter & Gamble and, therefore, owed Procter & Gamble a fiduciary duty in connection with its sale of swap agreements to Procter & Gamble); Complaint, Gibson Greetings, Inc. v. Bankers Trust Co., No. C-1-94-620 (S.D. Ohio 1994) [hereinafter *Gibson Greetings* Complaint].

5. The imposition of suitability standards on banks would introduce an unnecessary and undesirable element into the banker-client relationship. *See International Swaps and Derivatives Ass'n Before the Subcomm. on Fin. Inst. Supervision, Regulation and Deposit Ins. of the Comm. on Banking, Fin. and Urban Affairs: Hearing on the Derivatives Safety and Soundness Supervision Act of 1994, H.R. 4503*, 103d Cong. 139 (1994) (statement of Mark C. Brickell, Vice-Chairman, International Swaps and Derviatives Association), *available in* LEXIS, News Library, Fednew File. Brickell stated that suitability would "subject banks . . . to heightened compliance costs and likely lead to frivolous litigation." *Id.*; *see also* Geoffrey B. Goldman, *Crafting Suitability Requirement For The Sale Of Over-The-Counter Derivatives: Should Regulators "Punish The Wall Street Hounds Of Greed"?*, 95 COLUM. L. REV. 1112, 1146 (1995) (discussing the strong opposition to suitability bills).

6. *See Buyer Beware in the Derivatives Market*, 3 TREASURY MANAGER'S REP. NO. 5, Mar. 3, 1995, *available in* 1995 WL 6849420 [hereinafter TREASURY MANAGER'S REPORT]; *see also infra* Part IV.B (discussing why the derivatives transaction should be treated as an arm's length transaction). Law professor Henry T.C. Hu stated that

Currently, the only dealers potentially subject to suitability rules are those trading derivatives involving securities.[7] Specifically, broker-dealers trading exchange-listed derivatives are subject to suitability rules implemented by self-regulatory organizations with which they are required to register.[8] Dealers trading OTC derivatives instruments not involving securities are not subject to suitability rules.[9]

Self-regulatory organizations originally implemented suitability rules to protect retail customers from the aggressive sales tactics of brokers. The suitability doctrine obligates a broker-dealer to determine suitability if it makes a recommendation to a customer to trade in a certain security, or if it has discretionary authority over the customer's account to make trades on the customer's behalf.[10] Absent a recommendation, the broker is responsible for determining whether the risks associated with the investment are within the amount of risk the customer is capable of sustaining.[11]

Recently, the National Association of Securities Dealers ("NASD"), one of the self-regulatory organizations for the securities market, extended suitability obligations to broker-dealers trading securities to institutional customers.[12] The new suitability obligations require broker-dealers trading securities to institutional customers to recommend only suitable securities if the investor is not capable of understanding the risks associated with the investment or is not using its own independent judgment.[13] If the broker-dealer does not make a recommendation to an institutional customer, it is not required to assess suitability.[14]

Notwithstanding the suitability doctrine's limited application context, after the rash of losses in the derivatives market, Congress introduced a series of bills calling for the regulation of the derivatives

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"[suitability] rules would prevent the emergence of 'discount' derivatives dealers, who would offer low-cost transaction services in 'plain vanilla' swaps . . . ." *Id.*

7. *See infra* Part III.A.

8. *See infra* Part III.A.1.

9. *See* J. Christopher Kojima, *Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying the Federal Securities Laws to OTC Derivatives*, 33 AM. BUS. L.J. 259, 292 (1995).

10. *See, e.g.*, Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 242-44 (Cal. Ct. App. 1968).

11. *See* Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 449 (1965).

12. *See* 61 Fed. Reg. 44,100 (1996).

13. *See id.* at 44,105.

14. *See id.* at 44,106. An institutional customer is "an entity other than a natural person." *Id.*

market, including legislation that specifically imposes suitability requirements on all OTC derivatives dealers.[15] Regulators and market participants were reluctant to endorse Congress' view that a pervasive regulatory scheme was necessary in the OTC derivatives market.[16] Instead, regulators and market participants emphasized the need for internal controls and the implementation of voluntary frameworks.[17] Recognizing the uniqueness, complexity and global nature of the OTC derivatives market, regulators considered market discipline with limited federal oversight as a more feasible means of patrolling the derivatives market than the imposition of the suitability doctrine.[18]

After the market recovered from the initial losses, Congress retreated from its campaign of enacting legislation that regulates the OTC derivatives market.[19] In fact, recent pending federal legislation seeking to amend the Commodities Exchange Act ("CEA") suggests that Congress has come to agree with federal regulators' belief that subjecting derivatives transactions to regulatory frameworks modeled after existing regulatory standards is inconsistent with the nature of the

15. *See* H.R. 20, 104th Cong. (1995) (creating a Federal Derivatives Commission that would "establish principles and standards for the supervision and oversight of the derivatives market by Federal financial institution regulators"); H.R. 31, 104th Cong. (1995) (increasing the "supervision and regulation of the derivatives activities of financial institutions"); *see also* H.R. 1063, 104th Cong., (1995) (providing a framework for Securities and Exchange Commission ("SEC") supervision and regulation of derivatives activities); H.R. 718, 104th Cong. (1995) (establishing a Markets and Trading Commission to combine the functions of the Commodities Futures Trading Commission and the SEC in a single independent regulatory commission for purposes of regulating derivatives); H.R. 4503, 103d Cong. (1994) (requiring appropriate federal regulatory agencies to establish, among other things, standards for derivatives trading relating to capital, accounting, disclosure and suitability).

16. *See* Keith Bradsher, *Regulators See No Need for Tougher Rules on Derivatives*, N.Y. TIMES, Jan. 6, 1995, at D12.

17. *See SEC Chief Urges Internal Controls to Prevent Derivatives Losses*, REUTER BUS. REP., November 9, 1995, *available in* LEXIS, News Library, Reubus File (reporting SEC Chairman Arthur Levitt's statement that "[y]ou can't address fast changing instruments with ironclad regulations") [hereinafter *Chief Urges Internal Controls*].

18. In Congressional hearings, Federal Reserve Board Chairman Alan Greenspan testified that "[t]here is nothing involved in Federal regulation per se which makes it superior to market regulation. Indeed, if one looks into the future, what you can envision fairly readily is that the distinction between dealers and users is likely to diminish . . . . [A]nd as I indicated in my remarks a few moments ago, I believe that we have to become increasingly concerned about the question of oversight of the [derivatives] process as distinct from regulation." *Derivative Fin. Mkts. (Part I): Subcomm. on Telecomms. and Fin. of the Comm. on Energy and Commerce House of Representatives*, 103d Cong. 118 (1994).

19. *See Derivatives Disclosure Legislation Dead for This Congressional Session*, 26 SEC. REG. & L. REP. 1280, 1280 (1994) (noting that Congress indefinitely postponed proceeding forward with derivatives legislation in light of progress in the private sector and by financial regulators).

derivatives market.[20] The pending legislation seeks to exempt OTC derivatives transactions involving specified institutions and persons with assets exceeding $10 million from all but the anti-fraud provisions of the commodities laws.[21] Congress' bill reflects the view that the existing regulatory framework cannot be appropriately applied to OTC derivatives transactions that involve institutional investors negotiating very complex and unique transactions.

Federal Reserve Board ("the Fed") Chairman Alan Greenspan supports the amendments to the CEA. In a recent speech at the Federal Reserve Bank of Atlanta's Annual Financial Markets Conference, the Chairman stated:

> a one-size-fits-all approach to financial market regulation is almost never appropriate . . . . To cite an example, a government regulatory framework designed to protect retail investors from fraud or insolvency of brokers is unlikely to be necessary and is almost sure to be sub-optimal if applied to a market in which institutions transact on a principal-to-principal basis.[22]

This Article rejects the imposition of the suitability doctrine for OTC derivatives dealers.[23] Imposing suitability concepts to derivatives transactions is contrary to the risk-shifting principles that are an inherent part of the derivatives market. Investors use derivatives instruments as a means of transferring risk associated with the fluctuation of some underlying asset or reference rate ("underlying").[24] The derivatives contract's structure allows the investor to profit from the expected movement of an underlying.[25] If the underlying moves in a contrary direction, then the investor incurs a loss. To allow the investor to shift that loss is akin to compensating a gambler who loses a bet after the gambler has had full opportunity to negotiate the terms of the wager consistent with his or her goals. Just as a gambler must assume his or her losses as part of the wager, an investor who trades derivatives must assume responsibility for the transaction he or she chooses to enter.

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20. *See* S. 257, 105th Cong. § 5 (1997).

21. *See id.*

22. Alan Greenspan, Address at the Federal Reserve Bank of Atlanta's Annual Financial Markets Conference (Feb. 21, 1997), *available in* LEXIS, Nexis Library, NBC File.

23. *See infra* Part IV.

24. *See* Kojima, *supra* note 9, at 269.

25. *See id.*

This Article examines the derivatives market, its regulation and the concept of suitability as it applies—and should be applied—to the derivatives market. The Article first provides an overview of the derivatives market.[26] Next, the Article reviews the existing regulatory framework to which derivatives transactions and derivatives dealers are subject and also discusses the various legal actions that can be brought based on suitability claims.[27] The Article argues against the imposition of suitability rules to OTC derivatives dealers and instead emphasizes the need to view OTC derivatives transactions as arm's length transactions.[28] Finally, the Article identifies ways of achieving policy objectives concerning counter-party losses.[29]

II. THE DERIVATIVES MARKET

Financial derivatives began assuming a predominant role in the financial markets in the early 1970s, after the world's major industrial countries abandoned the Bretton Woods system of fixed currency rates.[30] During this period, the financial markets also faced an increase in the volatility of interest rates, resulting from governmental policy changes that permitted interest rates to fluctuate more freely.[31] With the increased volatility in both the exchange and interest rate systems, businesses faced new risks. Consequently, derivatives contracts emerged as vehicles to manage the newly faced risks and as a means of allowing traders to profit from market fluctuations.[32]

A. Classification of Derivatives Products

Derivatives contracts are bilateral agreements that derive their value from some underlying asset, such as stocks, commodities, or currency holdings, or from the value of some underlying reference or index rate, such as interest rates, exchange rates, or indices.[33] Most

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26. *See infra* Part II.

27. *See infra* Part III.

28. *See infra* Part IV.

29. *See infra* Part V.

30. Established in 1944, the Bretton Woods system maintained a fixed exchange rate regime by fixing non-U.S. currencies to the U.S. dollar. The system gave way to the current floating rate exchange system, which allowed exchange rates to change constantly in response to the pressures of demand and supply in the financial market. *See* KEITH REDHEAD, FINANCIAL DERIVATIVES 1 (1997).

31. The government attempted to manage exchange rate fluctuations by manipulating short-term interest rates, which consequently affected long-term interest rates. *See id.* at 2.

32. *See id.* at 2-3.

33. *See generally* ROBERT KOLB, FINANCIAL DERIVATIVES (1993) (providing general

derivatives contracts can be classified as either forward- or option-based derivatives contracts.[34]

Forward-based products obligate the holder of the forward contract to purchase the underlying at a specified future time for a specified price.[35] Option-based products provide the holder of the option the right, but not the obligation, to buy or to sell the underlying for a specified period of time at a designated price.[36]

1. Forward-Based Derivatives Products

Forward-based derivatives products include futures and forwards contracts, both of which are agreements that require the delivery of some underlying at a future date at a certain price.[37] However, futures differ from forwards contracts in several ways.[38] Forwards are customized, privately negotiated contracts that can involve long- or short-term obligations that typically do not exceed ten years and are relatively simple to use and understand.[39] In contrast, futures are standardized contracts that are usually short-term obligations not exceeding one year and which are traded through organized

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background information about derivatives). The title derivatives has also been given to certain "debt instruments that have payoff characteristics reflecting embedded derivatives or have option characteristics." GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 29 (1993). Instruments created by "'stripping' particular components of other instruments such as principal or interest payments" have also been termed "derivatives." *Id.* One example of a debt instrument termed a "derivative" is asset-backed securities such as collateralized mortgage obligations. *See* Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 999-1000 (1995). Some observers reject the use of derivatives to describe such debt instruments stating that the term derivative has been confused with securities that are intended to raise capital. *See id.*

34. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 28.

35. *See id.* at 30. The creation of forward-based contracts occurs from a variety of underlyings, including agricultural or physical commodities and currencies and interest rates. *See id.*

36. *See id.* at 32. The creation of option-based products occurs from a variety of underlyings, such as bonds, equities, currencies and commodities. *See id.* at 33.

37. *See* JOHN C. HULL, OPTIONS, FUTURES AND OTHER DERIVATIVES 1-4 (3d ed. 1997).

38. One of the ways futures differ from forwards contracts is that the delivery date in a futures contract is not specified. *See id.* at 4. The futures contract indicates delivery date by month, and the futures exchange dictates the time of the month when delivery must occur. *See id.*

39. *See id.* at 1-2. A forwards contract is usually between two institutional parties, one of which assumes a "long position" by agreeing to buy some underlying asset at some future date for a specified price. *See id.* at 1. The other party to the contract assumes a "short position" by agreeing to sell the underlying asset at the time and price agreed upon by the two parties. *See id.*

exchanges.[40] Additionally, parties to futures contracts are assured payment because the clearinghouse associated with the organized exchange guarantees the obligation of the contracting parties.[41]

One of the most widely used forward-based derivatives contract is the swap contract,[42] which can be categorized as a series of forwards contracts. Swaps are usually for longer terms than forwards or futures and, like forwards, may be difficult to cancel or reverse.[43] A swap contract is a bilateral agreement that obligates the contracting parties,

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40. Futures contracts are the traditional forward-based derivatives products that are actively traded on the futures market. *See id.* at 3. Although the futures market began by trading agricultural commodities as underlyings, it has developed to include financial futures based on currency, debt instruments, and financial indexes, all of which trade actively on the futures market. *See id.* at 4-5. Unlike forwards, delivery of the underlying in a futures contract is not required because a party can cancel its obligations by buying or selling offsetting positions, which is often done in futures market. *See id.* at 4. Futures are also marked-to-market at the end of each trading day so that any gains received by the price of the commodity moving away from the agreed upon price are received daily. *See* FRANK J. FABOZZI, VALUATION OF FIXED INCOME SECURITIES AND DERIVATIVES 192 (1995). Forwards, however, may not be marked-to-market, thus any gain or losses on forwards contracts may not be paid until the contract becomes due. *See id.*

41. *See* KOLB, *supra* note 33, at 25-31. An important institutional difference between forward and futures market is the existence of a clearinghouse. *See id.* at 24. Each of the futures exchanges established clearinghouses to guarantee performance of the futures contract. *See id.* The clearinghouse is interposed between the parties to a futures contract. *See id.* The clearinghouse becomes the seller to the purchaser of the futures contract and the purchaser to the seller of the contract. *See id.* at 24-25. The net position of the clearinghouse is always zero because it enters into both sides of the contract. *See id.* The absence of a clearinghouse in the forwards market subjects the contracting parties to far greater risk of non-performance than in the futures market. *See id.* at 23-24. Additionally, the clearinghouse provides a system that permits futures traders to cancel their positions, rather than make or take delivery of some underlying as required by the contract. *See id.* at 27. To cancel a futures position, futures investors must enter into an offsetting or reversing trade by instructing their brokers to enter into a transaction on the other side of the contract, which effectively offsets the original position. *See id.* For example, if investors are long, they can sell a contract. Upon the reversing transaction, the investors net out to zero because they hold both a long and a short position in the same contract. Effectively, the two contracts, one long and the other short, cancel each other out. The absence of a clearinghouse in the forwards market prevents either contracting party from canceling its position through offsetting transactions. *See id.*

42. *See* Joanne Morrison, *News and Trends: Derivatives Showed Gains in All Sectors, ISDA Say*, BOND BUYER, July 16, 1996, at 30. Morrison reported that an International Swaps and Dealer Association's ("ISDA"), a trade association of swap dealers, survey of 80 derivatives dealers compiled by the accounting firm Arthur Andersen found that the notional principal amount of transactions in interest rate swaps, currency swaps, and interest options stood at $17.713 trillion at the end of 1995, up from $11.303 trillion in 1994. *See id.*

43. *See* REDHEAD, *supra* note 30, at 3. Futures can be readily reversed because of the existence of a clearinghouse. *See* KOLB, *supra* note 33, at 27.

who are referred to as counter-parties, to exchange a series of cash-flow payments at specified times.[44] Perhaps the most popular swap is the interest-rate swap, which obligates one counter-party to make payments based on a fixed interest rate, while the other party has to make payments based on a floating interest rate.[45] A company with a floating-rate mortgage loan may be concerned that interest rates will rise. Instead of refinancing at a fixed rate, the company may enter into a swap contract to hedge against the risk of increases in the interest rate. Through a swap contract, the company can swap the floating-rate loan payment liability for a fixed-rate payment liability to insure against rises in the interest rate.[46]

2. Option-Based Derivatives Products

While forward-based derivatives products obligate a party to purchase an underlying, the holder of an option-based derivatives contract has the option, but not the obligation, to buy or sell the underlying for a specified period of time at a specified price, referred to as the strike price.[47] The option feature gives the option holder the benefit of profiting from the favorable movements of the market without being exposed to the corresponding losses.[48] A variety of

44. *See* REDHEAD, *supra* note 30, at 321. The cash flow payments are either fixed amounts or are determined by multiplying the amount of the underlying, a notional principal amount, by some designated price or reference rate. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 31. "Except for currency swaps, the notional principal is [only] used to calculate the payment stream," but the notional principal is not exchanged, which is why it is termed notional. *Id.*

45. *See* Morrison, *supra* note 42, at 30. Between 1994 and 1995, interest-rate swaps, which accounted for the majority of the OTC derivatives contracts, increased from $8.816 trillion to $12.811 trillion. *See id.* In an interest-rate swap, the most common floating rate is the London Interbank Offer Rate ("LIBOR"), which is the rate of interest offered by banks on deposits from other banks in the Euro currency markets. *See* HULL, *supra* note 37, at 111. Other swaps contracts include currency, commodity or equity swaps. In a currency swap, one counter-party swaps a specified amount of one currency to another counter-party in exchange for an equivalent amount of a different currency from the other counter-party. *See* KOLB, *supra* note 33, at 135-36. A company may desire to swap a liability in one currency for a liability in another currency to reduce its currency exposure. Equity swaps arise when counter-parties agree to exchange the returns on a stock index portfolio for a flow of interest payments. *See* REDHEAD, *supra* note 30, at 331.

46. Typically, the counter-party to the transaction is a financial institution that assumes the opposite side of the derivatives transaction. The counter-party acts as a dealer, holding an inventory of swap positions to be hedged or sold at a later time.

47. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 32.

48. *See* REDHEAD, *supra* note 30, at 3. The option holder has the advantage of ignoring the options contract if the rate or price of the underlying moves to a position that is not attractive. *See id.*

underlyings can create options, such as bonds, equities, currencies and commodities.[49]

Options contracts are one of the most popular option-based derivatives products. Options contracts include privately negotiated OTC options contracts, as well as exchange-traded options such as options on individual stocks, stock indices, interest rate instruments, precious metal indexes, foreign currencies, and future contracts.[50] Options contracts are either call or put options, either of which can be purchased by an investor at a price referred to as the premium.[51] In the case of exchange-traded options, a clearinghouse will assume the role of a counter-party to both the owner and writer of the option, thus guaranteeing performance of the options contract.[52] In contrast, OTC privately negotiated options contracts are not guaranteed through any clearinghouse; instead, both the owner and writer of the options contract assume the risk that the other party will perform the contract.[53]

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49. *See* HULL, *supra* note 37, at 5.

50. *See id.* at 4-5. Options on stocks began trading in 1973. Since that time, the options market has grown dramatically, evidenced by options trading on many exchanges throughout the world. *See id.*

51. *See* KOLB, *supra* note 33, at 77. An investor who purchases a call option receives the right to buy a specified instrument during a designated time period, while the purchase of a put option gives the investor the right to sell a specified instrument during a designated time period. *See id.* at 77-78. An investor purchases the option contract by paying the premium to the seller of the option, who is referred to as the writer of the option. *See id.* The writer of a call option agrees to sell the underlying instrument upon exercise of the option by the owner, and the writer of a put option agrees to purchase the underlying instrument upon exercise of the option by the owner. *See id.* The price at which the underlying stock will be paid if the option is exercised by the buyer is referred to as the strike price. *See id.* Option contracts typically expire within three to six months of writing them. *See id.* The definition of an option contract does not fit well with an option contract on a stock index, which is an option on an intangible that cannot be bought, sold, or held. *See* THE HANDBOOK OF DERIVATIVES AND SYNTHETICS: INNOVATIONS, TECHNOLOGIES AND STRATEGIES IN THE GLOBAL MARKETS 24 (Robert A. Klein & Jess Lederman 1994) [hereinafter DERIVATIVES AND SYNTHETICS]. An index option allows the "holder (buyer) [to] participate in the rise of an index (in case of a call option) or the fall of an index (in the case of a put option) . . . onwards over a given period of time (until the option's expiration date)." *Id.*

52. The single clearinghouse for U.S. exchanged traded options is the Options Clearing Corporation ("OCC"). *See* KOLB, *supra* note 33, at 7. The OCC operates in a manner similar to the clearinghouses for futures exchanges by acting as an intermediary in all options transactions, and by guaranteeing the options writer's performance. *See id.* As with the futures market, the buyer and seller of the options contract are not obliged to one another, but rather are obliged to the OCC. *See id.*

53. *See* Joseph L. Motes, III, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 S.M.U.L. REV. 579, 584-5 (1996).

Other options-based OTC contracts, such as caps, floors, collars, and swaptions, are widely used derivatives instruments.[54] Just as swaps are essentially a series of forwards, caps,[55] floors,[56] and collars[57] are each essentially a series of option contracts involving periodic cash flows. Finally, swaptions are options on swaps that give a buyer the right, but not the obligation, to purchase a swap contract at a specified date.[58] Unlike other option-based products, the underlying instrument associated with a swaption contract is another derivative. Combining derivatives contracts creates synthetic instruments used by many derivatives dealers to meet certain specific investor demand.[59] The process of combining derivatives with other financial instruments, derivatives or otherwise, is known as financial engineering.[60]

3. Exchange-Listed vs. OTC Derivatives Products

Derivatives can also be identified by the market in which they trade. Derivatives that trade through an organized public exchange are referred to as exchange-listed derivatives, which include both futures and exchange-listed options.[61] In contrast, derivatives contracts

54. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 33. An ISDA survey of 71 derivatives dealers found that interest rate options (caps, collars, floors, and swaptions) outstanding at year end 1995 stood at $3.704 trillion compared with $1.573 trillion a year earlier. *See* Morrison, *supra* note 42, at 30.

55. Interest-rate caps are a popular interest rate option offered by financial institutions in the OTC market. *See* HULL, *supra* note 37, at 397. A cap is an option agreement that places a ceiling or cap on an interest rate, rates of reference in a foreign exchange, or equity market. *See id.* A cap is a portfolio of call options. *See id.* at 398. At the inception of the contract, the buyer pays a premium to the seller who agrees to pay the buyer if on the designated reference date specified in the contract a reference rate is above the agreed upon cap rate. *See id.* A debtor with a floating rate loan can use a cap to protect against rises in the interest rates. *See id.*

56. A floor contract is the opposite of a cap. *See id.* at 399. Under the floor contract, a seller agrees to pay the buyer if the difference between the strike rate and reference rate is negative. *See id.* A floor is a portfolio of put options. *See id.* A floating-rate investor can use a floor to protect against a drop in interest rates. *See id.*

57. A collar is the contemporaneous purchase of a cap and the sell of a floor used with interest rates. *See id.* Collars can be used as a means of holding interest rates at a desired level. *See id.*

58. *See id.* at 131.

59. *See* DERIVATIVES AND SYNTHETICS, *supra* note 51, at 13.

60. Some of the synthetic instruments that can be created include straddles, strangles, bull spreads, and butterfly spreads. *See* KOLB, *supra* note 33, at 177-85 (discussing these techniques).

61. Twenty-five futures exchanges exist worldwide. *See* REDHEAD, *supra* note 30, at 6. The biggest futures exchanges are the Chicago Board of Trade ("CBOT") and the Chicago Mercantile Exchange. *See id.* Other U.S. futures exchanges are the Commodity Exchange of New York, the New York Mercantile Exchange, and the Coffee, Sugar and

privately negotiated between parties without a centralized market are referred to as OTC derivatives.[62] One of the big advantages of OTC derivatives products is the ability to customize the contract to provide solutions to the financial risks confronted by the contracting parties.[63] Exchange-listed derivatives contracts, which are standardized except for price, are less attractive to investors seeking to customize a contract to meet certain financial needs.[64] However, the downside to the customized nature of OTC derivatives contracts is that the customized terms render the contract less liquid for resale in the secondary market.[65]

A competitive advantage of exchange-traded products is the assurance that contractual obligations will be met because of the clearinghouse arrangement.[66] In response to this advantage, some major OTC derivatives dealers created special-purpose companies known as derivatives products companies ("DPC") for their derivatives activity.[67] A DPC is a subsidiary of the financial service firm that has a higher credit rating than its parent because its ability to fulfill its derivatives obligation to its counter-party is not dependent on

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Cocoa Exchange. *See* KOLB, *supra* note 33, at 23. U.S. options also trade on the Chicago Board of Trade, as well as the American Exchange, the Philadelphia Exchange, the Pacific Exchange, and the New York Stock Exchange. *See id.* at 79.

62. The ISDA developed a standard form contract for swaps that provides standard definitions and a list of options for handling certain issues that may arise with the swap transactions. *See* JOHN MARSHALL & KENNETH R. KAPNER, UNDERSTANDING SWAPS, 197 (1993). The standard form agreement also defines the counterparties' responsibilities in the event of default and termination. *See id.* at 198.

63. *See* DERIVATIVES AND SYNTHETICS, *supra* note 51, at 16, 41. To respond to this competitive advantage, in 1993 the Chicago Board Options Exchange initiated trading in FLexible EXchange ("FLEX") options, which more closely resembled customized OTC derivatives contracts. *See id.* The Philadelphia Stock Exchange also changed its contract specifications to resemble more closely customized derivatives contracts for currency options. *See id.* at 41.

64. *See* MARSHALL & KAPNER, *supra* note 62, at 3-4.

65. *See* JOHN MARSHALL & KENNETH R. KAPNER, THE SWAPS MARKET, 22-23 (2d ed. 1993).

66. *See* KOLB, *supra* note 33, at 24-25 for a discussion of clearinghouse function.

67. *See* DERIVATIVES AND SYNTHETICS, *supra* note 51, at 332. DPCs emerged after some of the initial losses in the derivatives market because some customers refused to purchase derivatives from dealers that did not have high credit ratings. Merrill Lynch Derivatives Product ("MLDP"), a subsidiary of Merrill Lynch, was the first triple-A DPC. *See* David Shireff, *Let's Rip Apart Those Triple-A Subs*, EUROMONEY, June 1996, at 120, 120-21. Following the creation of MLDP, five other securities firms imitated its structure: Sumitomo Bank (SBCM Derivative Products Ltd.), Tokai Bank (Tokai Derivative Products Ltd.), Lehman Brothers (Lehman Brothers Financial Products), Bear Stearns (Bear Stearns Financial Products) and NationsBank (Nationsbanc Financial Products). *See id.* at 121.

the financial resources of its parent.[68] Rather than entering into the derivatives contract with the financial firm with the lower credit rating, the counter-party enters into the derivatives contract with the better capitalized DPC.[69] Investors reasonably believe that entering into the derivatives contract with the well-capitalized DPC minimizes the chances of default.[70]

B. Market Participants

Whether traded over the counter or through an organized exchange, the market participants in the derivatives market can be divided into two parties: end-users and dealers.[71] End-users are, in most instances, sophisticated institutional investors and include financial institutions, commercial firms, mutual and pension funds, and some government entities that use derivatives contracts to manage financial risks that rise from their business investments.[72] Dealers are usually large banks, securities firms or their affiliates, and insurance companies or their affiliates, all of whom use derivatives for the same purposes as end-users. However, as dealers they also earn income by meeting the demand for derivatives.[73] Dealers, unlike end-users, can also act as

68. *See* DERIVATIVES AND SYNTHETICS, *supra* note 51, at 332. While several parent companies that are securities firms have received ratings of A+ on senior unsecured debt, their respective DPCs received AAA ratings. *See id.* Part of the reason the subsidiaries have been rated higher than their parent companies is because they have applied structured finance principles of credit-risk protection. *See id.* at 332-33. One way in which DPCs achieve credit support is through maintaining excess capital. *See id.* Both Merrill Lynch and Goldman Sachs have DPCs that are heavily capitalized and that restrict counter-parties to credit ratings of AA- or better. *See id.* at 333.

69. *See id.*; *see also* Olaf de Senerpont Domis, *NationsBank Gets OCC Nod on Derivatives: Ruling Is First to Allow Sales Through AAA-Rated Unit*, AM. BANKER, May 20, 1996, at 1. The OCC opened the door for NationsBank to operate derivatives products subsidiaries. *See id.* NationsBank Corp. was the first national bank permitted to operate a derivatives subsidiary, Nationsbanc Financial Product Inc., which was initially capitalized with $300 million from its parent. *See id.* at 2.

70. However, at least one analyst believes that some DPCs may not be able to withstand the financial ruin of their parent companies. *See* Shireff, *supra* note 67, at 120.

71. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 34.

72. *See id.*

73. *See* U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES 5 (1993). A large amount of the OTC derivatives activity in the U.S. is concentrated among 15 major U.S. dealers that are interconnected with one another, end-users, and the exchange-traded market. *See id.* at 6. In 1992, about 150 firms acted as derivatives dealers worldwide. *See id.* In recent years, the dominant dealers in the OTC derivatives market are six money-center commercial banks (Chemical Bank, Citibank, Morgan Guaranty, Bankers Trust New York, BankAmerica and Chase Manhattan Bank) and two U.S. securities firms (Salomon Brothers and Merrill Lynch), each having a derivatives book exceeding $1 trillion in notional value at year-end 1994. *See* Eli M. Remolona et al., *Risk*

market-makers by standing ready to make a two-way market in OTC derivatives products.[74] A dealer who acts as a market-maker will protect its position by entering into offsetting transaction with a second end-user or another dealer.[75] When a dealer does not act as a market maker, but rather brings two market participants to enter into a derivatives transaction, the dealer is acting as a broker.[76]

At the most fundamental level, derivatives instruments are risk-shifting devices that allow traders to use derivatives for one of three reasons: to hedge, to speculate, or to arbitrage.[77] Hedgers typically use derivatives to reduce financial risks associated with their existing asset/liability portfolios.[78] A hedger in the derivatives market protects itself by purchasing a derivative instrument that is expected to change in value in the opposite direction of the hedger's asset or liability.[79] For example, a United States company owing a debt of $1 million pounds to a British supplier due to be paid in ninety days is faced with the financial risk that on the date the obligation is due, the currency rate will have increased.[80] If the currency exchange rate on day one of the obligation is 1.605, the company can protect against an increase in the currency by entering into a long forward contract to buy $1 million pounds in ninety days for $1.605 million.[81] If the currency rate increases to 1.70 on day ninety, the company saves $94,400 because it protected itself against the increase with the purchase of the forward

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Management by Structured Derivative Products Companies, 2 ECON. POL'Y REV. 17, 18 (1996). Together, the six banks accounted for a total of $13 trillion, or about one-third of the global OTC derivatives market, which totals approximately $40 trillion in notional value. *See id.* at 18. The two securities firms are also major players, having the fifth and seventh largest derivatives books in the markets when ranked with the banks. *See id.*

74. *See* Kojima, *supra* note 9, at 300 n.165 (discussing a situation involving a derivatives dealer serving as broker to match two end-users of interest-rate swaps).

75. *See id.* at 300.

76. *See id.*

77. *See* HULL, *supra* note 37, at 10.

78. *See id.* at 11. Through financial engineering, derivatives instruments can also be used to create synthetic assets or liabilities which cannot be purchased through the organized exchanges. *See* REDHEAD, *supra* note 30, at 3.

79. Market participants use derivatives to hedge against adverse changes in the value of assets or liabilities that result from fluctuations in an interest rate, or exchange rate, or the price of stock, commodity or index. *See also* Anne Schwimmer, *Swaps Debate Spills Over into End-User Surveys: ISDA vs. Greenwich: Will the Real Numbers Please Stand Up?*, INVESTMENT DEALERS' DIG., July 15, 1996, at 11 (reporting that Greenwich Associates' survey of 4,000 end-users found that corporations looking to manage liability portfolios increased notional amounts of derivatives outstanding from $329 billion to $495 billion).

80. *See* HULL, *supra* note 37, at 11.

81. *See id.*

contract.[82]

Speculators buy and sell derivatives to make profits, not to reduce risk.[83] Investors may also purchase derivatives to speculate by attempting to profit from anticipated changes in the market rate or prices.[84] The speculators do not own the underlying, but instead use derivatives as a cheaper way to try to profit from movements in market rates or prices. Speculators can realize profits by betting on whether the price of an underlying, such as stocks, will rise or fall.[85] The speculator is merely required to pay a premium.[86] For example, if a stock price is $32 per share, a speculator who believes the price will rise can purchase a call option with a strike price of $35 for $.50 per option.[87] If the stock price does not rise to $35 during the life of option contract, the speculator loses $.50 per option or 100 percent of its investment.[88] But if the stock rises to $40, then the speculator realizes a profit of $4.50 per option or 900 percent of its original investment.[89]

Arbitrageurs allow traders to lock in riskless profits by taking advantage of the differences that exist between markets.[90] A call option to purchase 100 shares of stock for $50 per share creates an arbitrage opportunity if the price of the stock rises to $70 per share and the increased value of the option is not reflected in a different market. Once the stock rises to $70, the option is worth at least $2000, but if another market is selling the option for $1900, an arbitrageur can purchase the option from that market and make an immediate profit. The investor can exercise the option by purchasing the stock for $5000 and immediately selling it for $7000, instantly recognizing a profit.

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82. *See id.* If the currency rate decreases below 1.605, the company loses by entering into the forwards contract. *See id.*

83. Speculators are necessary parties to derivatives market because they facilitate hedging and assist in maintaining price stability.

84. *See* HULL, *supra* note 37, at 11.

85. *See id.*

86. *See id.* at 12 n.5.

87. *See id.* at 12.

88. *See id.*

89. *See id.*

90. *See id.* For example, if a company's stock is trading for $172 on an exchange in New York and is trading for 100 pounds on an exchange in London when the exchange is $1.7500 per pound, an arbitrageur can simultaneously purchase 100 shares of stock in New York and sell them in London to obtain a risk-free profit of $300, not including transaction costs. *See id.*

C. *Risks Associated with Derivatives Trading*

While derivatives contracts can be used to transfer risk associated with traditional financial instruments, they do not eliminate it. The two most important risks faced by derivatives users are credit and market risk.[91] Credit risk involves exposure to possible losses resulting from a counter-party's failure to meet its financial obligations.[92] The credit risks associated with OTC derivatives are substantially greater than those associated with exchange-traded derivatives. Investors who purchase exchange-traded derivatives are assured of payment from the central clearinghouse associated with the exchange in which the derivatives were purchased. However, counter-parties who purchase OTC derivatives do not have that same level of assurance because their derivatives contracts are negotiated with a counter-party whose creditworthiness must be relied upon in making the transaction.[93]

Market risk involves exposure to possible financial losses from an adverse movement in the interest or currency rates, equity or commodity prices, or other market factors.[94] The key to managing

91. *See* U.S. GENERAL ACCOUNTING OFFICE, *supra* note 73, at 56-66. Other risks faced by participants in the derivatives market include legal and operational risks. *See id.* Legal risk involves the possibility that a counter-party will incur a loss from a derivatives contract because a court or regulatory body invalidates the derivatives contract. *See id.* at 64. Another source of legal risk is that one of the counter-parties to the derivatives contract may lack the authority to have entered the contract. *See id.* at 65. OTC derivatives contracts are more likely to be subject to legal risk because exchange-traded derivatives have much more established legal standing. Operational risk involves the possibility of a loss because of inadequate systems, management failure, faulty controls, fraud, or human error in connection with the derivatives transaction. *See id.* at 66.

92. *See id.* at 52. Managing credit risk for OTC derivatives dealers may be difficult because credit exposure can change rapidly. *See id.* The key to managing both credit and market risk involves measuring it. *See id.* Measuring credit risk involves estimating the parties' current and potential credit exposures, and combining those estimates with the counter-parties' credit worthiness. *See* Remolona et al., *supra* note 73, at 20. Current exposures are the market values or replacement costs of the contracts to the counter-party at that time. *See id.* Potential exposures represent the values over time of contracts with possible future positive market values. *See id.* at 21. Measuring potential exposure requires counter-parties to use quantitative models that take in account market movements over time. *See id.* at 20.

93. The importance of derivatives dealers' creditworthiness brought about the creation of the first DPCs. After the initial losses in the derivatives markets, some investors refused to purchase derivatives from dealers unless they had high credit ratings. *See* DERIVATIVES AND SYNTHETICS, *supra* note 51, at 332.

94. *See* U.S. GENERAL ACCOUNTING OFFICE, *supra* note 73, at 60. Structured DPCs are generally established to eliminate market risk by contemporaneously entering into mirror transactions when transacting with a customer. *See* Remolona et al., *supra* note 73, at 23. Through a mirror transaction, a DPC insulates itself from market risk by engaging in collateralized hedging transactions with its parent or an affiliated company.

market risk is to measure the market risk. Measuring OTC derivatives' market risk is more difficult than measuring exchange-traded derivatives' market risk because OTC derivatives are not traded in a centralized market where prices are easily disclosed to the public.[95] Dealers in the OTC derivatives transactions rely on computer systems and advanced mathematical techniques to determine the value of derivatives.[96]

III. DERIVATIVES REGULATION

The extent to which derivatives dealers are subject to regulation depends on the type of derivatives instrument they are trading. Derivatives dealers trading exchange-listed and OTC derivatives instruments involving securities are subject to the regulatory authority of the Securities and Exchange Commission ("SEC").[97] Dealers trading exchange-listed derivatives instruments involving commodities, such as futures and commodities options, are subject to the regulatory authority of the Commodities Futures Trading Commission ("CFTC").[98] Derivatives dealers trading OTC derivatives involving commodities such as forwards are not subject to the regulatory authority of the CFTC.[99] Derivatives dealers trading swap agreements with certain institutional investors are exempt from all but the anti-fraud provisions of the CFTC laws.[100]

Additionally, banks acting as derivatives dealers trading OTC derivatives instruments are subject to certain banking regulation concerning derivatives trading. National banks acting as derivatives dealers are subject to the regulatory authority of Office of the Comptroller of the Currency ("OCC").[101] State member banks acting as derivatives dealers are subject to the Fed's authority, while state nonmember banks are subject to the jurisdiction of the Federal Deposit Insurance Corporation ("FDIC").[102]

See id.

95. *See* U.S. GENERAL ACCOUNTING OFFICE, *supra* note 73, at 61.

96. *See id.* at 60.

97. *See* COMMODITY FUTURES TRADING COMM'N, THE REPORT OF THE COMMODITIES FUTURES TRADING COMMISSION: OTC DERIVATIVE MARKETS AND THEIR REGULATION, 3A-3 (1993) (noting that securities derivatives are subject to the regulatory authority of the SEC); *see also* Kojima, *supra* note 9, at 292-93 (noting that OTC derivatives products are subject to the securities laws if they are considered securities).

98. *See* COMMODITY FUTURES TRADING COMM'N, *supra* note 97, at 3A-1.

99. *See* 7 U.S.C.A. §§ 1a(11), 2a(ii) (West Supp. 1997).

100. *See* Exemption of Swap Agreements, 17 C.F.R. § 35.2 (1997); *infra* note 247.

101. *See* U.S. GENERAL ACCOUNTING OFFICE, *supra* note 73, at 70.

102. *See id.*

Currently, the only derivatives dealers subject to suitability obligations are those trading derivatives involving securities. While the SEC does not have any suitability rules, the self-regulatory organizations ("SROs") for the securities market do have such rules.[103] Dealers who trade exchange-listed derivatives are required to register with at least one self-regulatory organization and thus are subject to their suitability rules.[104] Dealers that trade OTC derivatives involving securities are potentially subject to suitability obligations to the extent that they are required to register with the SEC and a self-regulatory agency.

Outside of the securities context, investors are required to make their own independent assessment about the suitability of the derivatives transactions they enter. The CFTC does not have any suitability rules.[105] The National Futures Association ("NFA"), the self-regulatory organization for the commodities market, likewise does not have any suitability rules. Like the CFTC, banking regulators have not imposed suitability obligations on banks that act as derivatives dealers.

A. SEC Regulatory Regime

The SEC has regulatory authority over exchange-traded derivatives transactions that consist of options on individual securities, options on certificates of deposit, and options on stock indices.[106] The SEC also has jurisdiction over OTC derivatives contracts involving securities.[107] Absent an exemption, the federal securities laws require broker-dealers, including those who engage in derivatives transactions involving securities, to register as broker-dealers with the Commission.[108] The federal securities laws also require registered broker-dealers to become a member of one or more SROs, such as NASD, the New York Stock Exchange ("NYSE"), and the other national exchanges that trade derivatives.[109]

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103. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 503 (1996).

104. *See id.* at 464.

105. *See* Protection of Commodity Customers, 42 Fed. Reg. 44, 742 (1977); *infra* note 219 and accompanying text.

106. *See* 15 U.S.C.A. §§ 77b(a)(1), 78c(a)(10) (West 1997).

107. *See id.*

108. *See* 15 U.S.C.A. § 78*o*(a) (West 1997). Registration requires broker-dealers to disclose the nature of their business and principal officers. *See* HAZEN, *supra* note 103, at 458 n.1. Broker-dealers are also required to disclose information relating to their financial condition. *See id.* (citing 17 C.F.R. § 240.15b(1)-(2)).

109. *See* HAZEN, *supra* note 103, at 464 (citing 15 U.S.C. § 78*o*(b)(8)).

Pursuant to an exemptive order, the SEC temporarily exempted broker-dealers engaged in trading certain swap agreements involving OTC options from the registration provisions of the securities laws.[110] The order, which expired in September 1995, exempted broker-dealers trading certain swap agreements from registering with the SEC during the exemptive period.[111] The SEC issued the exemptive order after its administrative proceeding against BT Securities Corporation in which the SEC found that certain Treasury-linked swap agreements were cash-settled options contracts subject to the regulatory authority of the SEC.[112] The SEC exempted those derivatives dealers trading swap agreements with embedded options on debt securities to provide them with adequate time to transfer such transactions from their unregulated affiliates to their regulated broker-dealer parents' balance sheets.[113] Exemption from registration released the dealers from suitability obligations imposed by the SROs during the exemptive period. Subsequent to the expiration of the exemptive order, broker-dealers trading such swap transactions became subject to the suitability rules imposed by the SROs with which their parent securities firms were registered.

Broker-dealers trading OTC derivatives not involving securities transact these trades through their unregistered affiliates to avoid the reporting and capital requirements to which registered broker-dealers are subject. Even though these broker-dealers are not subject to suitability obligations, the SEC oversees their derivatives activity

110. *See* Order Exempting Certain Brokers and Dealers from Broker-Dealer Registration, Exchange Act Release No. 35,135, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,476, at 86,107 (Dec. 22, 1994) (temporarily exempting broker-dealers trading certain OTC derivatives from registration requirements under section 15(a) of the Exchange Act) [hereinafter SEC Exemptive Order]. The exemption was retroactive to June 6, 1934, the date of the enactment of the Securities Exchange Act of 1934 and expired on September 30, 1995. *See id.* The exemption referred to individually negotiated, cash-settled OTC options on debt securities or groups of indices of such securities that were swap agreements complying with exemption requirements set forth by the CFTC in 17 C.F.R. Part 35. *See id.* at 86,108.

111. *See id.*

112. *See In re* BT Securities Corp., Exchange Act Release No. 35,136, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477, at 86,109 (Dec. 22, 1994). BT Securities, a subsidiary of Bankers Trust, submitted an offer of settlement consenting to SEC findings that it had engaged in fraud in connection with a Treasury-linked swap agreement offered and sold to Gibson Greetings, Inc. *See id.* at 86,115. The SEC findings stated that the Treasury-linked swap agreement was actually a cash settled put option written by Gibson Greeting. *See id.* at 86,112. The exemptive order issued by the SEC refers to the Treasury-linked swap and a knock-out call option, both of which the SEC characterized as securities in the BT Securities settlement. *See* SEC Exemptive Order, *supra* note 110, at 86,108.

113. *See* SEC Exemptive Order, *supra* note 110, at 86,108.

pursuant to regulatory authority granted the SEC by the Market Reform Act of 1990 ("MRA").[114] Under the MRA, the SEC has the authority to obtain from unregistered affiliates certain information about their derivatives activity, including those derivatives transactions that do not involve securities.[115] Pursuant to the MRA, the SEC adopted rules establishing a risk-assessment program that requires the largest broker-dealers to establish record-keeping and reporting requirements regarding any affiliate's financial condition that may have a material impact on the broker-dealer.[116] Unregistered affiliates must also provide the SEC with quarterly reports on derivatives positions and details on the internal controls and risk management implemented by the affiliate.[117]

1. The Suitability Doctrine

While the federal securities laws do not impose a suitability rule, each of the SROs have some form of suitability rule that requires broker-dealers to recommend only suitable securities to their customers.[118] The SROs originally adopted suitability rules to protect retail customers engaging in securities transactions against inappropriate sales practices such as churning and boiler-room sales tactics.[119] These rules generally require broker-dealers who either have control over a customer's trading decisions through a discretionary account, or who recommend securities to retail customers

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114. *See* 15 U.S.C. § 78a (West 1997).

115. *See id.*

116. *See* Risk Assessment Reporting Requirements for Brokers and Dealers, 17 C.F.R. § 240.17h-2T(c) (1997).

117. *See id.*

118. Federal securities laws do not contain any provisions requiring dealers to recommend only suitable securities to its customers. The SEC has used the shingle theory in defining the standard of care that a broker-dealer owes its customer. *See* HAZEN, *supra* note 103, at 501. Under the shingle theory, if the broker holds itself out as an expert in the securities transaction, the broker is held to a higher standard of care in making recommendations. *See id.* Liability under the shingle theory discourages a broker-dealer from recommending a security unless the broker is knowledgeable about the characteristics and relevant facts concerning the security being recommended. *See id.*

119. *See* Mundheim, *supra* note 11, at 456-60. The NASD implemented suitability rules after a special study endorsed by Congress emphasized the need to protect investors from overselling and from aggressive merchandising of securities. *See id.* at 459. The Special Study on Securities Market spearheaded the implementation of the doctrine, emphasizing that SEC disclosure requirements and practices did not completely protect investors. *See id.* The Study stressed that investor protection required additional measures that focused on the practices of the broker because the broker is the key to selling the securities. *See id.*

to obtain information regarding the customer's financial circumstances and investment objectives.[120] Based on the information provided by the customer, the broker-dealer is required to determine whether the security is suitable for the customer.[121] The enforcement of the suitability requirements will depend on the specific rules implemented by the various self-regulatory organizations.

The NYSE's suitability requirements provide that in recommending a purchase or sale of a security, a broker-dealer member must "[u]se due diligence to learn the essential facts relative to" each customer, order, customer cash or margin account, and each person holding power of attorney over any account.[122] The NYSE also has a specific suitability rule applicable to options transactions that requires a person recommending the sale or purchase of options contracts to have a reasonable belief that the customer possesses the requisite knowledge to understand, and the ability to bear the risks of the options transactions.[123] The American Stock Exchange ("AMEX") adopted provisions similar to the NYSE.[124]

The NASD has a general suitability rule that requires broker-dealers recommending securities to have a reasonable basis for the recommendation of the particular security or strategy.[125] The rule also requires that the broker-dealer believe that the recommendation made to the customer is suitable.[126] Recommendations made to retail customers require the broker-dealer to make reasonable efforts to obtain information about the customer's financial and tax status, investment objectives, and any other information considered reasonable and necessary to make a recommendation to a customer.[127] The NASD also has a specific suitability rule that governs

120. Under the suitability doctrine, a broker is obliged to determine suitability if it makes a recommendation to a customer to trade in a certain security or if it has discretionary authority over the customer's account to make trades on the customer's behalf. *See, e.g.*, Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 242-44 (Cal. Ct. App. 1968). Absent a recommendation, the broker also has a responsibility to determine whether the risks associated with the investment are within the amount of risk the customer is capable of sustaining. *See* Mundheim, *supra* note 11, at 449.

121. *See* Mundheim, *supra* note 11, at 449.

122. *See* 2 New York Stock Exchange Guide (CCH) ¶ 2405, 1011, 3696 (1992).

123. *See id.* at 4560.

124. *See* American Stock Exchange Guide (CCH) ¶ 9431, 2647 (1995).

125. *See* NASD Manual (CCH), Rule 2310, at 4261 (1997) [hereinafter NASD Manual].

126. *See id.*

127. *See id.*

recommendations of options transactions.[128] The options suitability rule is identical to the general suitability rule except that it contains an additional requirement that obliges the broker to have a reasonable belief that (1) the customer has the knowledge and financial experience sufficient to understand the risk of the recommended options transaction and (2) the customer is financially able to bear the risks of the transaction.[129]

The NASD recently issued an interpretation to its suitability rules clarifying that the rule is also applicable to securities transactions involving institutional customers.[130] The new suitability interpretations identify two primary considerations that a broker must evaluate in determining the scope of its suitability obligation to an institutional customer.[131] First, the broker must determine the customer's ability to evaluate investment risk.[132] Second, the broker must determine the customer's ability to make independent investment decisions.[133] Accordingly, if the broker determines that the customer

128. *See* NASD Manual, *supra* note 125, Rule 2860(b)(19), at 4727; *id.* ¶ 2183, at 2168 (1995).

129. *See id.* at 2168.

130. *See* 61 Fed. Reg. 44,100 (1996). Pursuant to the Government Securities Act Amendments of 1993, which expanded the sales practice authority of the NASD to regulate dealer sales activity in exempted securities, the NASD issued new suitability interpretation for broker-dealers selling not only government equity and debt securities but also all other securities, except municipal securities. *See id.* NASD defines an institutional customer as "any entity other than a natural person." *Id.* at 44,106. The NASD indicates that the definition of institutional customer is not determined by reference to a "threshold institutional asset size or portfolio size or various statutory designations." *Id.* While the NASD's interpretation is potentially applicable to any institutional customer, it notes that the "interpretation is more appropriately applicable to an entity having at least $10 million invested in securities in the aggregate in its portfolio or under management." *Id.*

131. *See id.* at 41,111.

132. *See id.* at 44,105. The NASD identifies four factors that the broker should consider in determining whether the customer is capable of evaluating investment risk: (1) the existence of any oral or written agreement between the customer and the broker-dealer concerning the customer's reliance on the broker-dealer's recommendation; (2) the presence or absence of any pattern of acceptance of the broker-dealer's recommendation by the customer; (3) the customer's use of ideas, suggestions, market views, and information obtained from other broker-dealers or market professionals relating to the same type of securities; and (4) the extent to which the customer provided the broker-dealer with current comprehensive portfolio information in connection with recommended transactions, or did not provide important information about its portfolio or investment objectives. *See id.*

133. *See id.* The NASD identifies the five following factors that a broker-dealer should consider in determining whether the customer is capable of making independent investment decisions: (1) the customer's use of one or more consultants, investment advisers or bank trust departments; (2) the general level of experience of the staff of the institutional customer in financial markets and specific experience with the type of

is capable of evaluating its investment risk and making independent investment decisions, the broker-dealer fulfills its obligation under the suitability rule.[134] On the other hand, if the broker determines that the customer is not capable of evaluating investment risk or that the customer is not using its own independent judgment, then the broker must recommend only suitable securities to the customer.[135] The NASD has also issued a policy statement regarding new products and risky instruments that requires broker dealers to familiarize themselves with the financial situation and trading experience of the customer trading such instruments.[136]

2. Private Rights of Action Under the Suitability Rule

Generally, an injured investor will be unable to initiate an action against a broker-dealer solely on the basis of a suitability rule violation.[137] However, an injured investor may have a private right of action against a broker-dealer for damages under the anti-fraud provisions of the securities laws if the broker-dealer recommending the investment engaged in fraudulent sales practices in connection with an unsuitable transaction and the customer relied on this fraud.[138] Specifically, an end-user seeking redress for a derivatives loss can bring a suitability action under Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, if the

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instruments under consideration; (3) the capability to understand the securities' economic features displayed by the customer; (4) the customer's ability to evaluate independently how market developments would affect the security being recommended; and (5) the complexity of the security or securities involved. *See id.*

134. *See id.* at 44,105-06.

135. *See id.*

136. *See* NASD Manual, *supra* note 125, IM-2310-2(e), at 4263. The policy also requires the broker-dealer to assess the customer's risk threshold and the customer's awareness of pertinent information pertaining to the product. *See id.*

137. *See, e.g.*, Craighead v. E.F. Hutton & Co., 899 F.2d 485, 493 (6th Cir. 1990) (finding no private right of action in federal court under the NYSE "know your customer" rule); Carrot v. Shearson Hayden Stone, Inc., 724 F.2d 821, 823 (9th Cir. 1984) (finding the same result as *Craighead*); Pyle v. White, 796 F. Supp. 380, 385 (S.D. Ind. 1992) (citing *Craighead*, 899 F.2d at 493) (stating that "[t]he weight of more recent authority is against implying a cause of action under NASD suitability and NYSE know-your-customer rules").

138. *See* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031-33 (2d Cir. 1993) (finding that a suitability claim failed because investors could not show justifiable reliance on misrepresentation); O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 899-900 (10th Cir. 1992) (finding that a suitability claim failed because plaintiff did not show the degree of recklessness required to establish scienter); Shamsi v. Dean Witter Reynolds, Inc., 743 F. Supp. 87, 91 (D. Mass. 1989) (dismissing a suitability claim due to plaintiff's failure to satisfy Rule 10b-5 deception requirement).

derivatives instrument involves a security.[139] End-users can bring a suitability action based on a misrepresentation, an omission, or fraud-by-conduct claim.[140] However, sophisticated investors such as end-users have been held to a higher standard of proof when alleging such claims against broker-dealers.[141]

a. Suitability Actions Based on a Misrepresentation Claim

Under Section 10(b) and Rule 10b-5, an investor can bring a suitability action alleging that the broker, acting with scienter, made a material misrepresentation about the suitability of a security.[142] To satisfy the scienter requirement, the investor must show that the broker purchased the securities with an intent to defraud or with reckless disregard for the end-user's interest.[143] Generally, courts find the scienter requirement satisfied if the investor proves that the broker intentionally or recklessly recommended unsuitable securities that were too risky in light of the investor's objective.[144] However, the scienter requirement is not met if the broker's recommendation was based on negligence or ignorance.[145]

To bring a suitability action for misrepresentation, an investor must establish that the securities were unsuitable, given the investor's objectives, and that the broker knew the unsuitability of the securities but recommended them anyway.[146] Investors must also prove that they have justifiably relied to their detriment on the broker's

139. *See* 15 U.S.C. § 78j(b) (1995); 17 C.F.R. § 240.10b-5 (1997).

140. *See* Mark C. Jensen, *Abuse of Discretion Claims Under Rule 10b-5: Churning, Unsuitability and Unauthorized Transactions*, 18 SEC. REG. J. 374, 384-90 (1991).

141. *See* Cremi v. Brown, 955 F. Supp. 499, 511-12 (D. Md. 1997), *aff'd*, Banca Cremi v. Alex Brown & Sons, 132 F.3d 1017 (4th Cir. 1997).

142. *See O'Connor*, 965 F.2d at 897-98.

143. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that fraud actions brought under anti-fraud provisions of the securities laws must allege that defendant possessed scienter, defined as an intent to defraud, manipulate, or deceive); *see also O'Connor*, 965 F.2d at 899 (stating that to prove unsuitability, a plaintiff must show that a "broker purchased . . . securities with an intent to defraud or with reckless disregard for the investor's interests").

144. *See* Jensen, *supra* note 140, at 385-86.

145. *See* Clark v. John Lamula Investors, Inc., 583 F.2d 594, 601 (2d Cir. 1978).

146. *See* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993); *see also* Craighead v. E.F. Hutton & Co., 899 F.2d 485, 493 (6th Cir. 1990). In *Craighead*, the court rejected plaintiff's unsuitability claim because the investor failed to plead with particularity the securities transactions that were unsuitable and reasons why they were unsuitable. *See Craighead*, 899 F.2d at 493-94. The court stated that plaintiffs alleging to be victims of unsuitable trades must do more than allege that their broker's purchase was inconsistent with their trading objectives. *See id.* at 494.

recommendation.[147] Most courts find that an investor may not claim justifiable reliance on the misrepresentations of a broker if, through minimal diligence, the investor should have uncovered the truth about the security.[148]

Courts balance various factors to determine whether an individual investor acted recklessly and, therefore, did not justifiably rely on the misrepresentation made by the broker.[149] Some of the relevant factors used by courts include: (1) "[t]he sophistication and expertise of the [investor] in financial and securities matters"; (2) "the existence of longstanding business or personal relationships" between the investor and broker; (3) the investor's "access to the relevant information" concerning the security; (4) "the existence of a fiduciary relationship" between the investor and the broker; (5) "the opportunity to detect fraud"; and (6) "the generality or specificity of the misrepresentations."[150] The level of the investor's sophistication is a dominant factor used by courts to determine whether the investor's reliance was justified.[151]

Courts are reluctant to find that sophisticated investors have justifiably relied on recommendations made by their brokers.[152] In a recent derivatives case, *Banca Cremi*, a Mexican investment bank purchased risky collaterized mortgage obligations ("CMOs") from Alex Brown, a derivatives dealer, and asserted that the dealer engaged in fraud under Section 10(b) of the securities laws by making material misrepresentations that misled the bank into making volatile investments.[153] Banca Cremi incurred a loss of more than $23 million from the derivatives trades.[154] The federal district court granted

147. *See Brown*, 991 F.2d at 1031.

148. *See id.* at 1032 (citing Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1015-16 (2d Cir. 1989)).

149. *See Royal Am.*, 885 F.2d at 1016.

150. *Brown*, 991 F.2d at 1032..

151. *See* Banca Cremi v. Brown, 955 F. Supp. 499, 511 (D. Md. 1997) (noting that the level of an institutional investor's sophistication and expertise is significant and highly dispositive in determining whether the investor justifiably relied on the misrepresentations of the derivatives dealer), *aff'd*, Banca Cremi v. Alex Brown & Sons, 132 F.3d 1017 (4th Cir. 1997); *see also* Platsis v. E.F. Hutton & Co., 642 F. Supp. 1277, 1299 (W.D. Mich. 1986) (holding that investor sophistication is dispositive), *aff'd*, 829 F.2d 13 (6th Cir. 1987); Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 632 F. Supp. 471, 481-83 (D. Me. 1986) (discussing individual investor sophistication).

152. *See, e.g.*, Kennedy v. Josephthal & Co., 814 F.2d 798, 804-05 (1st Cir. 1987); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677-78 (9th Cir. 1982); Hirsch v. duPont, 553 F.2d 750, 762-63 (2d Cir. 1977).

153. *See Banca Cremi*, 955 F. Supp. at 501-02.

154. *See id.* at 501.

summary judgment to Alex Brown, finding Banca Cremi to be a sophisticated investor who had failed to prove that it had justifiably relied on the statements made by Alex Brown concerning the derivatives instruments.[155] In reaching its decision, the court emphasized that a sophisticated investor must engage in an increased degree of due diligence before it can justifiably rely on representations made by a derivatives dealer.[156] Unlike a retail customer, an end-user typically has sophistication and expertise in financial and securities matters, and ordinarily consults independent advisers regarding their investment decisions. Therefore, the reliance requirement may make it difficult for end-users to prove that they were unaware of the need to perform an independent evaluation of the derivatives transactions into which they entered.[157] In *Hirsch v. duPont*,[158] the Second Circuit Court stated that "[t]he securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information."[159]

b. Suitability Actions Based on an Omission Claim

As with a misrepresentation claim, a suitability action based on an omission claim also requires the investor to prove that the securities were unsuitable, given the investor's objectives, and that the broker knew or reasonably believed that the securities were unsuitable but recommended them anyway.[160] However, instead of establishing that the broker made a material misrepresentation, the investor must prove that the broker, acting with scienter, failed to disclose material information about the unsuitability of the security.[161] Accordingly, the investor must establish the existence of a fiduciary relationship that requires the broker to disclose such information.[162]

Generally, courts hold that the existence of a broker-customer relationship does not constitute a fiduciary relationship, unless the

155. *See id.* at 517.

156. *See id.*

157. *See Hirsch*, 553 F.2d at 762-63.

158. 553 F.2d 750 (2d Cir. 1977).

159. *Id.* at 763.

160. *See* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993).

161. *See* O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 897 (10th Cir. 1992).

162. *See* Dirks v. SEC, 463 U.S. 646, 653-54 (1982) (holding that a duty to disclose information arises from the existence of a fiduciary relationship) (citing Chiarella v. United States, 445 U.S. 222, 227-35 (1980)).

broker has control over trading decisions.[163] Courts have been particularly reluctant to find the existence of a fiduciary relationship between a broker-dealer and a sophisticated investor, unless the broker has exercised control through a discretionary account.[164] An end-user may have difficulty proving the existence of a fiduciary relationship with an OTC derivatives dealer because it is unlikely that a derivatives dealer could exercise discretionary authority over an OTC derivatives transaction. While a securities account lends itself to being controlled by a broker-dealer, an OTC derivatives contract reflects a transaction between two parties that requires each party to negotiate terms of the contract consistent with their financial objectives. Moreover, courts reject end-users' claims that derivatives dealers with whom they have traded owe the end-users a fiduciary duty.[165] Rather, courts find that both the end-user and the derivatives dealer are principals in the derivatives contract.[166]

c. Suitability Action Based on Fraud by Conduct

A suitability action also can be brought under Section 10(b) and Rule 10b-5 for fraudulent conduct arising out of a broker's recommendation of unsuitable securities.[167] A suitability claim based on fraud by conduct is analogous to a churning claim.[168] In fact, many suitability claims based on fraud by conduct include claims of

163. *See* Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 212 (7th Cir. 1993); Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 460-61 (9th Cir. 1986); Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154, 155 (1st Cir. 1986); Shamsi v. Dean Witter Reynolds, Inc., 743 F. Supp. 87, 92 (D. Mass 1989); Rush v. Oppenheimer & Co., 681 F. Supp. 1045, 1055 (S.D.N.Y. 1988).

164. *See* Bull v. Chandler, No. C-86-5710 MHP, 1992 WL 103686, at *7 (N.D. Cal. 1992). A fiduciary relationship exists where one party places special confidence and responsibility in the other, and the other party gains some benefit from the relationship. *See* MidAmerica Fed. Sav. & Loan v. Shearson/American Express, Inc., 886 F.2d 1249, 1257-58 (10th Cir. 1989); *see also Lefkowitz*, 804 F.2d at 155 (holding that an investor's personal relationship with and reliance on his broker, coupled with the investor's lack of business expertise, did not create a fiduciary duty).

165. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1286, 1289 (S.D. Ohio 1996); *see also* State v. Morgan Stanley & Co., 459 S.E.2d 906, 913 (W. Va. 1995)

166. *See Procter & Gamble Co.*, 925 F. Supp at 1286; *see also Morgan Stanley Co.*, 459 S.E.2d at 913.

167. *See* O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 897 (10th Cir. 1992).

168. *See id.* at 898. Churning involves excessive trading in account by a broker contrary to the investor's objectives. To establish a churning claim, an investor must prove that: "(1) trading in the account is excessive in light of the investor's objective; (2) the broker exercised control over trading in the account; and (3) the broker acted with an intent to defraud or with willful disregard for the investor's interest." *Id.*

churning, making it difficult to analyze the claims separately.[169] In *O'Connor v. R.F. Lafferty & Co.*,[170] O'Connor, an investor, unsuccessfully brought a suitability action against a broker-dealer who purchased several securities through a discretionary account that were unsuitable for O'Connor's investment objectives.[171] O'Connor did not allege that the broker made material misrepresentations or omissions concerning the securities purchased.[172] Instead, she asserted a suitability claim based on fraud by conduct in light of the excessive trading of unsuitable securities.[173]

The *O'Connor* court held that to sustain a fraud-by-conduct suitability claim, an investor must prove that: (1) the broker recommended (or, in the case of a discretionary account, purchased) securities which are unsuitable in light of the investor's objectives; (2) the broker recommended or purchased the securities with an intent to defraud or with reckless disregard for the investor's interests; and (3) the broker exercised control over the investor's account.[174]

The fraud-by-conduct suitability claim is distinguished from the misrepresentation or omission claim by the addition of the control element.[175] An investor can establish that a broker exercised control over an account by proving that the broker had discretionary authority over the account.[176] Even if the broker does not have discretionary authority, the investor can also establish that the broker exercised control by proving that the investor routinely followed the broker's advice.[177]

Courts, however, are reluctant to find that sophisticated investors have relinquished control of their accounts simply because they have routinely followed the advice of their brokers.[178] Only in situations where the sophisticated investor allows the broker to control trading decisions through a discretionary account do courts find that a

169. *See* Jensen, *supra* note 140, at 387.

170. 965 F.2d 893 (10th Cir. 1992).

171. *See id.* at 895-96.

172. *See id.* at 897-98.

173. *See id.*

174. *See id.* at 898.

175. *See id.*

176. *See* Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980).

177. *See* Follansbee v. Davis Skaggs & Co., 681 F.2d 673, 676-77 (9th Cir. 1982); *Mihara*, 619 F.2d at 821; Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F. Supp. 951, 954 (E.D. Mich. 1978), *aff'd* 647 F.2d 165 (6th Cir. 1981).

178. *See* Tiernan v. Blyth, Eastman, Dillion & Co., 719 F.2d 1, 3 (1st Cir. 1983); *Follansbee*, 681 F.2d at 677.

sophisticated investor has relinquished control.[179] End-users may have difficulty establishing that they have relinquished control of their derivatives trading to a derivatives dealer. Sophisticated investors, such as end-users engaging in a complex derivatives transaction, are expected to negotiate the derivatives contract in a manner that protects their financial interests. It is unlikely that derivatives transactions could be subject to churning in the manner that broker-dealers can churn securities accounts. It is even more unlikely that end-users would permit a derivatives dealer to engage in such behavior.

d. Suitability Actions Based on Common Law

End-users have been successful in bringing tort actions against derivatives dealers who fail to disclose material information concerning the risks associated with derivatives trades they recommend.[180] Several end-users have initiated legal proceedings against derivatives dealers, alleging that the dealers engaged in fraud by failing to disclose material risks associated with the derivatives instruments recommended to the end-users.[181] Some end-users also allege that the dealer's failure to disclose such risks constituted a breach of fiduciary duty owed to the end-user.[182] Many of these cases brought by end-users alleging fraud and/or breach of fiduciary duty are settled out of court.[183]

179. *See Follansbee*, 681 F.2d at 677; *see also* Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975).

180. *See* Stuart D. Root, *Suitability–The Sophisticated Investor–And Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 344-47 (1991) (discussing the common-law causes of action that can be brought against broker-dealers who fail to disclose the risks associated with securities investments).

181. *See* Complaint, Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp 1270 (S.D. Ohio 1996) (No. C-1-94-735) (alleging that Bankers Trust engaged in fraud and breached a fiduciary duty owed to Procter & Gamble by failing to disclose material information concerning the risks associated with two swap agreements) [hereinafter Procter & Gamble Complaint]; *see also* Gibson Greetings Complaint, *supra* note 4 (alleging that Bankers Trust engaged in fraud and breached a fiduciary duty owed to Gibson Greetings by failing to disclose material information concerning the risks associated with a swap agreement); Gregory C. Baumann, *Fallout From Derivative Sales Still Raining on Alex Brown*, DAILY REC., July 15, 1996, at 1 (reporting that Banca Cremi initiated legal proceedings against Alex Brown, derivatives dealer, alleging that Alex Brown engaged in fraud by recommending unsuitable derivatives instruments to Banco Cremi); Knecht, *supra* note 2, at 1 (reporting that various derivatives dealers, including Piper Jaffray and Merrill Lynch, had been sued for fraud for failing to disclose material risks associated with derivatives transactions recommended by the dealers).

182. *See* Procter & Gamble Complaint, *supra* note 181, at 2; *see also* Gibson Greetings Complaint, *supra* note 4, at 25.

183. *See* Neal St. Anthony, *Piper Settles Class-Action Suit*, STAR TRIB., June 22, 1996, at 1D (reporting that Piper Jaffray settled for $15.5 million a class-action lawsuit

In one such case, *Procter & Gamble Co. v. Bankers Trust Co.*,[184] Procter & Gamble, an end-user, sought declaratory relief and damages with respect to two interest rate swap transactions for which Bankers Trust, the derivatives dealers, claimed it was owed $200 million.[185] Procter & Gamble challenged the legal enforceability of the two derivatives trades.[186] The core of Procter & Gamble's legal action against Bankers Trust was a common-law fraud count based on failure to disclose material information concerning the risks associated with the swap trades.[187] Procter & Gamble alleged a number of other counts, including an allegation that Bankers Trust owed and breached a fiduciary duty to Procter & Gamble because it failed to disclose risks associated with the derivatives transactions.[188]

The United States District Court for the Southern District of Ohio dismissed all of the counts, except for the fraud count.[189] The court found that no fiduciary relationship existed between Procter & Gamble and Bankers Trust,[190] finding instead that both parties were principals in the derivatives transaction.[191]

The court held that Procter & Gamble could proceed on its fraud claim.[192] The court found that under New York law, the agreement between the parties contained an implied covenant of good faith and fair dealing that imposed upon Bankers Trust a duty to disclose material information concerning risks associated with the derivatives trades.[193] Procter & Gamble never proceeded on the fraud claim because Bankers Trust settled the legal action by agreeing to receive a reduced amount of $35 million from Procter & Gamble for the

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brought by investors who lost money from mutual funds purchased from Piper Jaffray that were loaded with derivatives); *see also* Denis Forster, *Derivatives Law in the Aftermath of Procter & Gamble v. Bankers Trust*, DERIVATIVES LITIG. REP., Sept. 16, 1996, at 3 (reporting that Bankers Trust settled an action brought by Procter & Gamble alleging that derivatives loss was due to Bankers Trust's failure to disclose risks associated with the derivatives transaction); Michael Quint, *Gibson Suit on Trades Is Settled*, N.Y. TIMES, Nov. 24, 1994, at D1 (reporting that Bankers Trust, the derivatives dealer, settled with Gibsons Greetings by forgiving $14.5 million of the $20.7 million that Gibson owed under its derivatives contract).

184. 925 F. Supp. 1270 (S.D. Ohio 1996).
185. *See id.*
186. *See id.* at 1289-90.
187. *See id.* at 1289.
188. *See id.*
189. *See id.*
190. *See id.* at 1286.
191. *See id.*
192. *See id.* at 1289.
193. *See id.* at 1289-91.

obligation it owed on the two disputed swap agreements.[194]

Absent the parties' settlement, the court's opinion would have allowed Procter & Gamble to establish a common-law fraud case based on a breach of a duty to disclose material information. The court's holding in this case suggests that while derivatives dealers may not owe a fiduciary duty to end-users, the dealers may have a duty to disclose material information regarding risks associated with the derivatives trades. Failure to disclose such information may constitute fraud.

In another derivatives case, *State v. Morgan Stanley & Co.*,[195] the State of West Virginia brought a legal action against Morgan Stanley, an investment banking firm.[196] West Virginia alleged that Morgan Stanley engaged in constructive fraud in connection with transactions with state fiduciaries who invested state monies in speculative derivatives investments resulting in a $280 million loss.[197] The trial court issued a summary judgment in the amount of $52 million, ruling that Morgan Stanley knowingly aided and abetted the staff of the State Investment Division, a state agency, in violating their fiduciary duty to West Virginia Consolidated Fund, a state investment fund, by speculating in violation of West Virginia law.[198] A jury also found Morgan Stanley liable for constructive fraud based on the speculation claim.[199]

The Supreme Court of Appeals of West Virginia reversed the lower court ruling. This court held that the issue of constructive fraud was a jury question and that "the jury's finding of constructive fraud was based on a finding of illegality on which the trial court should *not* have given a binding instruction."[200] The court remanded the case to allow Morgan Stanley to explain to the jury what it understood "speculation" to mean within the context of West Virginia law.[201] Morgan Stanley was also allowed to establish that it acted in good faith and with honest

194. *See* Forster, *supra* note 183, at 3. The parties also agreed to cancel a third swap agreement and to permit Procter & Gamble to retain $4.1 million it had received from the two disputed swap agreements. *See id.*

195. 459 S.E.2d 906 (W. Va. 1995).

196. *See id.* at 910.

197. *See id.* The state initiated legal proceedings against several other Wall Street firms that paid $28 million to settle claims arising from their involvement in the derivatives trading with the State. *See id.*

198. *See id.* at 911.

199. *See id.* at 912.

200. *See id.* at 913.

201. *See id.* at 921.

intent to benefit the fiduciary estate.[202] The court ruled that if the jury found on remand that Morgan Stanley's actions were innocent of any intentional wrongdoing, the jury could offset losses that arose from speculation with gains that arose from the direct result of the same type of speculation.[203]

The court's holding in this case is instructive in identifying possible dealer liability in cases involving derivatives losses incurred by municipalities. Dealers engaging in derivatives transactions with municipalities may be subject to liability under a theory of aiding and abetting if state laws prohibit speculative trading. Since what constitutes "speculation" appears to be a jury question, its definition will depend on the jurisdiction in which the case arises. The case is also instructive because it provides a framework for determining the amount of damages an end-user can obtain in situations where the end-user has also profited from the derivatives trading.

3. SEC Actions Concerning OTC Derivatives Transactions

The SEC and SROs have enforced suitability rules against broker dealers through censures, fines, suspension, expulsion, and other disciplinary sanctions available under the SROs. Specifically, Section 10(b) and Rule 10b-5 hold brokers liable for making material misrepresentations or intentional omissions in recommending unsuitable investments.[204] The NASD recently fined and disciplined Piper Jaffray, a mutual fund dealer, for improperly marketing and selling a mutual fund that contained high-risk, mortgage-backed derivatives.[205] According to the NASD, Jaffray marketed the derivatives to investors; these investments were unsuitable in light of investors' age, financial status, goals, and investment experience.[206] Without admitting or denying the allegations, Piper Jaffray consented to a finding that the firm's brokers recommended and sold certain mutual funds without disclosing material facts to investors about the characteristics and risks of the fund.[207]

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202. *See id.*

203. *See id.* at 920.

204. *See* Lee S. Richards & Arthur S. Greenspan, *Suitability Issues in Derivatives Trading*, N.Y.L.J. 1 (1995).

205. *See* Ted Sickinger, *Broker Hit with Big Fine: Piper Jaffray Cited for Improper Marketing of High-Risk Derivatives*, KANSAS CITY STAR, Mar. 7, 1996, at B1, *available in* LEXIS, News Library, Kcstar File.

206. *See id.*

207. *See id.*

To date, however, the SEC has not attempted to enforce the suitability doctrine against OTC derivatives dealers that have failed to disclose risks to its counter-parties.[208] The SEC has used the anti-fraud provisions as weapons against such derivatives dealers, but has declined to include issues of suitability as part of its enforcement actions against derivatives dealers. For example, the SEC successfully brought an anti-fraud enforcement action against BT Securities, a securities dealer, for making material misrepresentations and omissions to Gibson Greetings, an investor, in the offer and sale of a treasury linked swap agreement.[209] The SEC found that BT Securities failed to disclose the riskiness of the derivatives securities to Gibson, and also lied to Gibson about the extent of the losses it was incurring from its derivatives positions.[210] The administrative order finding BT Securities liable for violations of the anti-fraud provisions specifically noted that the case did not involve findings relating to the suitability of the derivatives products sold to Gibson.[211] BT Securities offered a settlement by paying a penalty of $10 million without admitting or denying the findings made by the SEC.

Another example of such enforcement actions against derivatives dealers is SEC action taken against Kenneth Schulte, a registered representative for various broker-dealers, in which the SEC alleged that Schulte, using aggressive and intimidating sales tactics, offered and sold millions of mortgage-back security derivatives without disclosing to his customers the nature or risk of the derivatives transactions.[212] The SEC successfully brought an administrative proceeding against Schulte for violations of the anti-fraud provisions,

208. *See* Joan E. McKown & Anita T. Purcell, *Enforcement Actions Involving Derivatives: BT Securities Corp. and Beyond*, 65 U. CIN. L. REV. 117, 127 n.40 (1996) (stating that thus far suitability issues have not been addressed in any enforcement action involving derivatives).

209. In the Matter of BT Securities Corporation, Exchange Act Release No. 35,136, Admin. Proc. File No. 3-8579, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477 (Dec. 22, 1994). The Commission found that the Treasury-linked swap sold by BT Securities to Gibson was actually a cash-settled option written by Gibson. *See id.* at 86,112 n.6. The option was initially based on a spread between the price of the 7.625%, 30-year U.S. Treasury security maturing on November 15, 2002, and the arithmetic average of the bid and offered yields of the most recently cautioned obligation of a two-year Treasury note. *See id.* The option was based on a notional amount of $30 million. *See id.*

210. *See id.* at 86,114.

211. *See id.* at 86,110 n.2.

212. *See In re* Kenneth J. Schulte, Exchange Act Release No. 110, [1994-95 Transfer Binder], 64 SEC Docket 704 (Apr. 10, 1997).

but the proceeding did not include issues of suitability.[213] Additionally, there is a pending SEC investigation of Merrill Lynch that is also focusing on whether Merrill Lynch failed to disclose a risky investment strategy and other material information in the offering of documents for certain municipal note issues.[214] Thus far, it appears that the SEC is considering charging an individual at Merrill Lynch under the anti-fraud provisions, but not under the suitability doctrine.

B. CFTC Regulatory Regime

Neither the Commodities Futures Trading Commission nor the National Futures Association, the self-regulatory organization for the commodities market have suitability rules.[215] The absence of such rules suggests that end-users trading in OTC derivative products involving commodities are required to make independent assessments about the suitability of such transactions in light of their financial condition.

1. Exchange-Traded Derivative Transactions

The CFTC has exclusive jurisdiction over futures contracts and commodity options, both of which must be traded on a board or national exchange.[216] Market professionals engaged in futures trading are required to register with the CFTC.[217] Like the SEC, neither the CFTC nor the self-regulatory NFA have any suitability requirements. Although the NFA has a "know-your-customer" rule, which obligates the futures commission merchant ("FCM") to obtain information about

213. *See id.* at 710. Schulte was barred from associating with a broker, dealer, a member of a national securities exchange, or registered securities association, and from participating in an offering of penny stock. *See id.*

214. *See* Lynn Stevens Hume, *SEC Nears Close of Enforcement Case Against Merrill over Orange County*, BOND BUYER, June 23, 1997, at 1 (reporting that sources close to SEC investigation expect the Commission to take some sort of action against Merrill by either filing or settling securities fraud charges), *available in* LEXIS, Bankng Library, Bndbyr File.

215. *See* Conrad G. Bahlke, *"Suitability" and "Appropriateness" of Derivative Instruments*, *in* DERIVATIVES AVOIDING RISK AND MANAGING LITIGATION 1996, at 29, 41-44 (PLI Corp. Law & Practice Course Handbook Series No. B-931, 1996).

216. *See* 7 U.S.C.A. § 2a(ii) (West 1995).

217. *See* 7 U.S.C. §§ 6d, 6e, 6m (1980). Market professionals in the commodities market include futures commission merchants ("FCM"), introducing brokers, floor brokers, commodity trading advisers and commodity pool operators. FCMs are brokerage firms that sell commodities. *See id.* § 6d(1). Introducing brokers solicit or accept trade orders. *See id.* § 6e. Floor brokers execute orders on the exchange floor. *See id.* Commodity trading advisers give advice about commodities trading. *See id.* § 6m(1) (1994). Commodity pool operators are analogous to a mutual fund operator. *See id.*

a customer before opening an account.[218] This rule does not require that futures professionals ensure that an investment recommended be suitable for their customer.[219]

In 1977, the CFTC proposed, but eventually rejected the imposition of a suitability rule on futures professionals.[220] The suitability rule would have required FCMs to obtain information concerning a customer's financial condition and trading objectives before recommending a futures transaction.[221] FCMs also would have been required to have a reasonable belief that the transactions recommended were suitable for the customer in view of the customer's financial condition.[222] The CFTC declined to adopt the rule because it was unable "to formulate meaningful standards of universal application."[223] The opposition to the suitability rule stemmed from the belief that although appropriate in the securities context, it could not be appropriately applied to futures transactions.[224] Because securities transactions involve varying degrees of risk, depending upon the particular security, a broker can adequately assess suitability based on the security in question.[225] However, futures transactions are inherently risky, rendering the assessment of suitability more problematic.[226] The proposed suitability rule was criticized for requiring FCMs to assess suitability in view of the risk of loss associated with a particular trade but failing to require the FCM to disclose to its customers which types of trades were considered to have higher or lower risk.[227]

Instead of imposing suitability obligations on futures professionals, the CFTC issued a rule requiring FCMs opening accounts to provide their customers with risk disclosure statements.[228] The risk disclosure statement contains language that informs the customer that futures trading is risky and that one should "carefully consider whether such

218. *See* Bahlke, *supra* note 215, at 44.

219. *See id.* The NFA "know-your-customer" Rule 2-30 requires every member to obtain information about the customer. *See id.*

220. *See* Protection of Commodity Customers, 42 Fed. Reg. 44,742 (1977).

221. *See id.* at 44,743-44.

222. *See id.*

223. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,888 (1978).

224. *See* Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431, 1505 (1991).

225. *See id.*

226. *See id.*

227. *See id.*

228. *See* Customer Protection Rules, 43 Fed. Reg. at 31,886, 31,888.

trading is suitable . . . in light of your circumstances and financial resources."[229] The issuance of the risk disclosure statement to its customers suggests that the CFTC places the responsibility for determining the suitability of an investment on the customer, rather than on the market professional with whom the customer trades.

2. OTC Derivatives Transactions

The CEA gives the CFTC exclusive jurisdiction to regulate all transactions involving contractual agreements providing for the sale of a commodity for future delivery.[230] The term "commodity" is statutorily defined as including all "goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[231] The broad statutory definition of commodities coupled with the exclusive jurisdiction clause granting the CFTC regulatory authority over contracts for future delivery arguably places several OTC derivatives contracts within the scope of the CFTC's jurisdiction. To limit the CFTC's jurisdictional scope, Congress specifically excludes some OTC derivatives transactions from its jurisdiction and grants the CFTC authority to exempt other types of OTC derivative transactions from its jurisdiction.[232]

Forwards contracts, while similar to futures contracts, are excluded from the regulatory jurisdiction of the CFTC.[233] Forwards, like futures, are contracts involving the future delivery of commodities. However, futures involve contracts entered into for speculative purposes in which delivery of the commodity often does not occur. In contrast, forwards contracts generally involve commercial, merchandising transactions in physical commodities in which the parties intend to deliver the commodity but delivery is delayed for

229. *Id.* at 31,888.

230. *See* 7 U.S.C.A. § 2(i) (West Supp. 1997). The Commodities Exchange Act grants the CFTC exclusive jurisdiction with respect to "accounts, agreements (including any transaction which is of the character of . . . an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange or market . . . ." *Id.*

231. *Id.* § 1a(3). The 1974 amendments to the CEA that created the CFTC expanded the coverage of the statute to include non-agricultural commodities "in which contracts for future delivery are presently or in the future dealt in." 88 Stat. 1395 (1974).

232. *See* 7 U.S.C.A. §§ 1a(11), 2a(ii) (West Supp. 1997). The CEA specifically excludes two types of transactions from CFTC jurisdiction, forwards and transactions involving foreign currency not traded on a board of trade. *See id.*

233. In 1922, when futures became subject to federal regulation, Congress exempted forwards contracts from regulation under the "deferred delivery" provision. *See id.* § 1a(11).

some commercial reason.[234] Forwards are excluded from CEA's regulation because the CEA's regulatory scheme was not intended to apply to private commercial merchandising transactions involving the deferred delivery of a commodity.[235]

The foreign exchange forward market is also excluded from CFTC's jurisdiction pursuant to the treasury amendment, which Congress enacted to insure that off-exchange market transactions in foreign currency would not be subject to CFTC's regulatory jurisdiction.[236] In *Dunn v. CFTC*,[237] a recent case, the Supreme Court found that transactions in foreign currency excluded from the CFTC's regulatory jurisdiction include not only futures contracts involving foreign currency, but also options contracts in foreign currency.[238] In that case, the CFTC alleged that Dunn and others solicited investments and operated a fraudulent scheme in violation of the anti-fraud provisions of the CEA.[239] The investments involved options to purchase or sell various foreign currencies that were traded "off-exchange" or through the "over-the-counter" market, instead of through a board of trade or regulated exchange.[240] The customers incurred substantial losses, and subsequently the CFTC initiated proceedings against the petitioners.[241] Dunn and other petitioners argued that their off-exchange transactions in foreign currency were exempt from the CFTC's jurisdiction because the treasury amendment

234. *See* COMMODITY FUTURES TRADING COMM'N, *supra* note 97, at 3A-8. To distinguish forwards from futures contracts, the CFTC identifies, and courts endorse, certain institutional features associated with the futures market that operate as guideposts in determining whether a contract is a future or forward. The following features associated with futures trading are defined by the CFTC as the basic elements of 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 actual commodities." Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 25 (1996). Courts repeatedly hold that the lack of delivery of the underlying indicates that the transaction was speculative, qualifying it as a futures rather than forwards contract. *See id.*

235. *See* COMMODITY FUTURES TRADING COMM'N, *supra* note 97, at 3A-9.

236. *See* 7 U.S.C.A. § 2(ii) (West 1994 & Supp. 1997). The "Treasury Amendment" provides that nothing in the CEA applies to "transactions in foreign currency, security warrants, security rights, [or] resales . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade." *Id.*

237. 117 S. Ct. 913 (1997).

238. *See id.* at 915.

239. *See id.*

240. *See id.* "Off-exchange" or through the "over-the-counter" market was defined by the Court as direct contracts and transactions with international banks and other private parties not on a regulated exchange. *See id.* at 913.

241. *See id.* at 915.

to the CEA provides that nothing in the CEA applies to "transactions in foreign currency." [242] The CFTC argued that an option in foreign currency is not a transaction "in" foreign currency but rather a contract right to engage in such a transaction at a future date, bringing it within the jurisdiction of the CFTC.[243] The Supreme Court sided with the petitioner, finding that foreign currency options are "transactions in future currency" within the meaning of the statute.[244]

The broad jurisdictional authority granted the CFTC through the statutory definition of a commodity led many OTC derivatives participants to be concerned whether swap agreements were subject to the regulatory scope of the CFTC. In response to those concerns, Congress enacted the Futures Trading Practice Act of 1992 that granted the CFTC the authority to exempt from its jurisdiction certain transactions between appropriate persons[245] without determining whether the transactions were futures contracts.[246] Pursuant to its exemptive authority, the CFTC promulgated Rule 35, which exempts swaps agreements between certain classes of investors, specified institutions, and persons with assets over $10 million from operation of all but the anti-fraud and manipulation provisions of the CEA.[247]

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242. *See id.*

243. *See id.* at 916.

244. *See id.* The Court explained, "[t]he more normal reading of the key phrase encompasses all transactions in which foreign currency is the fungible good whose fluctuating market price provides the motive for trading." *Id.*

245. Appropriate persons include banks and trust companies, investment companies, commodity pools, employee benefit plans, governmental entities, broker-dealers, FCMs, business entities meeting certain minimum asset or net worth tests, and "[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections." Futures Trading Practice Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (codified at 7 U.S.C.A. § 6(c)(3) (West Supp. 1997)).

246. *See* Futures Practices Trading Act of 1992, Pub. L. No. 104-9, § 1, 109 Stat. 154 (1992) (codified at 7 U.S.C.A. § 6(c)(3) (West Supp. 1997)).

247. *See* Exemption of Swap Agreements, 17 C.F.R. § 35 (1997). Rule 35 defines a swap agreement as an agreement that is a "rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement . . . ." *Id.* § 35.1(b)(1)(i). The rule states that the swap agreement must be entered into between eligible swap participants. *See id.* § 35.1(b)(2). Entities that may qualify as eligible swap participants include: (1) banks or trust companies; (2) savings associations or credit unions; (3) insurance companies; (4) investment companies subject to regulation under the Investment Company Act of 1940; (5) commodity pools formed and operated by persons subject to regulation under the CEA (provided that such commodity pool has total assets exceeding $5 million); (6) corporations or other entities with total assets exceeding $10 million whose obligations are guaranteed or otherwise supported by certain other eligible swap participants, or where the swap is entered into in connection with the conduct of their business, whose net worth exceeds $1 million governmental entities; (7) broker-dealers

The CFTC's exemption of certain swap agreements and the exclusion of the forwards market from its jurisdiction reflects the CFTC's and Congress' view that parties entering into such contracts are institutional customers who do not need of the protection of the CFTC.[248] This view is also reflected in recent pending legislation that seeks to amend the CEA to provide exemption from all but the anti-fraud provisions of the CEA for appropriate persons trading OTC derivatives instruments.[249]

C. Bank Regulatory Regime

1. Bank Suitability Obligations

Recently, the OCC, the Fed, and the FDIC issued suitability rules for depository institutions within their respective jurisdictions that act as government securities broker-dealers.[250] The Government Securities Act of 1993 serves as the impetus for the suitability rule, authorizing the agencies to adopt rules governing transactions in government securities to provide consistent treatment for government securities customers regardless of whether they engage in transactions in government securities with banks or non-bank government securities brokers or dealers.[251] Prior to adoption of a suitability rule by the agencies, banks engaging in government securities trades were

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subject to regulation of the SEC under the 1934 Act; or (8) FCMs, floor brokers, or floor traders subject to the regulation of the CEA; (9) natural persons with total assets exceeding at least $10 million; and (10) certain foreign persons subject to foreign regulation. *See id.*

248. In a speech addressing the Chicago Kent-ITT Commodities Law Institute Conference, Brooksley Born, chairperson of the CFTC stated that,

> [u]nlike the futures exchanges which we regulate, the domestic over-the counter market is restricted to contacts between sophisticated persons or institutions and does not involve the participation of the general public. In my view, it is appropriate that regulation of this market should be limited to issues relating to fraud and manipulation.

Chairwoman Brooksley Born, Address at Chicago Kent-ITT Commodities Law Institute Conference (Nov. 18, 1996), *in* 10 INT'L SEC. REG. REP 20, 20 (1996).

249. *See* Commodities Exchange Amendments Act of 1997, S. 257, 105th Cong. § 5 (1997). The legislation effectively seeks to codify the swap agreement exemptions implemented by the CFTC through its exemptive authority. *See* 17 C.F.R. § 35 (1997).

250. *See* Government Securities Sales Practices, 62 Fed. Reg. 13,276 (1997) (to be codified at 12 C.F.R. pt. 13, 12 C.F.R. pts. 208 and 211, and 12 C.F.R. pt. 368). National banks are subject to the OCC jurisdiction, state member banks are subject to the Board of Governors of Federal Reserve jurisdiction, and state nonmember banks and insured state branches of foreign banks are subject to the jurisdiction of the Federal Deposit Insurance Corporation. *See id.*

251. *See id.*

not subject to suitability requirements, while non-bank broker-dealers were subject to the suitability requirements imposed by self-regulatory agencies like the NASD.

The suitability rule implemented by the agencies is substantially similar to the NASD suitability rule for institutional customers.[252] Essentially, the rule requires banks engaging in transactions involving government securities to have "reasonable grounds for believing that recommendations are suitable for a customer based on the facts, if any, disclosed by a customer regarding his or her securities holdings and financial situation and needs."[253] Like the NASD suitability rules, if the customer is a non-institutional customer, the bank must make reasonable efforts to obtain information about the customer's financial condition and tax status and investment goals before completing a transaction it recommends to its customer.[254] Also like the NASD suitability rule, the two most important considerations in determining the bank's obligation in making recommendations to institutional customers is the customer's ability to evaluate risk independently and the extent to which the customer is exercising independent judgment in evaluating the bank's recommendation.[255] Under the suitability rule, if a bank has reasonable grounds to believe that an institutional customer is making independent investment decisions and is capable of evaluating investment risk independently, then the bank's obligation under the suitability rules is fulfilled.[256]

2. OTC Derivatives Transactions

Over the past few years, commercial banks in the United States have been dominant players in the OTC derivatives market.[257] To insure the

252. *See supra* notes 130-36 and accompanying text.

253. 62 Fed. Reg. 13,276 (1997).

254. *See id.* "A non-institutional customer means any customer other than (i) A bank, savings association, insurance company, or registered investment company; (ii) An investment adviser registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3); or (iii) Any entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million." *Id.* at 13,285.

255. *See id.* at 13,277. The agencies identified factors that can assist banks in determining whether the customer is capable of evaluating risk independently and ascertaining whether customers are exercising their own independent judgment in evaluating the bank's recommendation. These factors mirror those identified by the NASD's Suitability Rules. *See supra* notes 132-33.

256. *See* 62 Fed. Reg. at 13,277.

257. *See* Comptroller of the Currency Admin. of Nat'l Banks, News Release: Derivatives Volume Rises to $22 Trillion; Record Trading Revenues of $2.4 Billion During 1st Quarter, No. NR 97-63 (Wash. D.C., July 1, 1997), at 1-2; *see also* Remolona et al., *supra* note 73, at 18 (reporting that six U.S. money-center commercial banks and

safety and soundness of the banks engaging in derivatives activity, banking regulators have implemented certain guidelines that banks engaging in derivatives transactions must follow. The OCC and the Fed have established guidelines for banks that engage in OTC derivatives activities as dealers and as end-users.[258] The guidelines have been established to ensure that banks engaging in derivatives transactions understand the risk associated with its derivatives activity. The guidelines do not impose suitability obligations on banks acting as derivatives dealers.

a. OCC Guidelines Established for Derivatives Trading

The OCC issued supervisory guidelines entitled "OCC Banking Circular 277" ("Circular"), which provides guidance for derivatives trading with counter-parties.[259] The purpose of the Circular is to ensure that banks conduct financial derivatives activities in a safe and sound manner.[260] To ensure safety and soundness, the Circular contains provisions that require credit officers approving derivatives transactions to focus on whether a particular derivatives transaction is appropriate for its customer.[261] In order to comply with the appropriateness standard, banks that act as derivatives dealers must identify whether a proposed derivatives transaction is consistent with a customer's policies and procedures as they are known to the bank.[262] Management must also be able to analyze the impact of the proposed derivatives transaction on the customer's financial condition and understand the applicability of derivatives instruments to the risks that customer is attempting to manage.[263]

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two U.S. securities firms have been the dominant intermediaries in the OTC markets, with each having a derivatives book exceeding $1 trillion in notional value at year-end 1994–top banks were Chemical Bank, Citibank, Morgan Guaranty, Bankers Trust NY, BankAmerica and Chase Manhattan).

258. *See* Bahlke, *supra* note 215, at 47-62.

259. *See* Comptroller of the Currency Admin. of Nat'l Banks, Banking Issuance, No. BC-277 (Oct. 27, 1993). With the issuance of BC 277, the OCC became the first bank regulator to address the matter of appropriateness in connection with derivative dealing activities. *See id.*

260. *See id.*

261. BC-277 is addressed to and provides guidance to national banks and federally insured licensed branches and agencies of foreign banks that engage in derivatives activities. *See id.*

262. *See id.* at 12. Specifically, Section C1 of the BC-277, entitled "Credit Approval Function" lists various guidelines that credit officers must follow in connection with approving a derivatives transaction for a customer that focus on the appropriateness of the transaction for the customer. *See id.*

263. *See id.*

The Circular was originally understood as imposing suitability obligations on those banks acting as derivatives dealers.[264] The OCC responded by issuing a Question and Answers interpretative release that explicitly stated that the OCC was not adopting suitability standards.[265] The release stated that banks engaging in derivatives transactions are not required to determine if the transaction is suitable, rather, they are only required to determine if the transaction is appropriate for the customer in view of the customer's policy and procedures as they are known by the bank.[266] The OCC clarified its position by drawing a contrast between its guidelines and the NASD's suitability rules.[267] OCC noted that the NASD suitability rule requires a dealer to obtain specific information and determine suitability before recommending a transaction to a non-institutional customer.[268] In contrast, the OCC emphasized that its guidelines were not requiring bank dealers to obtain information and review its counter-party's policies.[269] The release indicates that a bank must ensure that the customer understands the risks associated with a particular derivatives transaction.[270] The release also requires the bank to explain to the customer how the transaction will achieve the counter-parties' financial objective.[271] The OCC's position suggests that bank dealers, unlike NASD broker-dealers, do not have an affirmative duty to seek information about the customer's business in determining the appropriateness of the transactions.

While the OCC has not imposed suitability obligations on banks engaging in derivatives activity, it has issued a Handbook which advises banks of the "need to understand reasonably well the nature of each counter-party's business and the purpose of its derivatives activities."[272] The Handbook distinguishes the level of inquiry and understanding that managers must implement depending upon the

264. *See* Comptroller of the Currency Admin. of Nat'l Banks, OCC Bulletin, No. 94-31 (May 10, 1994).

265. *See id.* at 14.

266. *See id.* at 15.

267. *See id.*

268. *See id.*

269. *See id.*

270. *See id.*

271. *See id.* at 16. The release provides additional instruction by stating that if the bank determines that the derivatives transaction is inappropriate but the customer wishes to proceed with the transaction, the bank need only document its analysis and the information given to the customer. *See id.*

272. Bahlke, *supra* note 215, at 18-19.

sophistication of the customer.[273] For customers considered to be dealers or sophisticated end-users, one should note that these are market professionals who will be using the derivatives products for market-making or risk management.[274] For less sophisticated customers, dealers need to attempt to understand the particular risk that a customer is trying to manage and ascertain whether or not the derivatives product under consideration is an appropriate tool for that customer.[275] While the appropriateness guidelines issued by the OCC may come close to suitability requirements, the guidelines were implemented to ensure that banks conduct their derivatives activity in a safe and sound manner.[276] The OCC views the relationship between the bank and its customer as a principal-to-principal relationship, not as an advisory one.[277]

b. Federal Reserve Board Sales Practices Guidelines

The Fed has issued guidelines for trading activities of State member banks that are applicable to derivatives trading.[278] These supervisory

273. *See id.* at 19-20.

274. *See id.*

275. The Handbook provides further guidance on this requirement by stating that the credit officer should review the usual and customary credit file information, including the customer's risk profile, business characteristics and plans, financial statements, and the type and purpose of credit facilities to sufficiently evaluate the appropriateness of the transaction. *See id.*

276. The Senior Deputy Comptroller for Capitol Markets at OCC stated that the OCC Circular "is not a suitability rule. We acknowledge that it comes very close, but there are several ways in which section C1 is distinguishable from the suitability rule applicable to U.S. Broker/dealers. First and foremost, the motivation behind that particular element of our guidance is not customer protection, but rather ensuring that banks are conducting all of their activities in a safe and sound manner." Douglas E. Harris, Senior Deputy Comptroller for Capital Markets, Remarks Before the International Swaps and Derivatives Association, Barcelona, Spain (Mar. 23, 1995), *in* Bahlke, *supra* note 215, at 74.

277. During the speech to the ISDA in Barcelona, Spain, Harris stated that "[t]hese [derivatives] transactions are similar to other bank services and transactions, such as loans, deposits and letters of credit, are entered into on a principal-to-principal basis. The bank does not act as broker to or agent for the customer; the bank is not selling an obligation (or the equity) of another party to its customer as an asset; the bank is not considered a fiduciary of the customer." *Id.*

278. *See* Fed. Res. Bd., Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations, No. SR 93-69 (Dec. 20, 1993), *reprinted in* Bahlke, *supra* note 215, at 55-56 [hereinafter Banking Organizations]. To complement its trading activities guidelines, the FRB has also issued end-user guidelines entitled that require the bank to understand the instruments that it holds. *See* Fed. Res. Bd., Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities, No. SR 95-17 (Mar. 28, 1995), *reprinted in* Bahlke, *supra* note 215, at 56.

examiner guidelines are not customer protection rules. The guidelines instruct banks engaging in trading activities to evaluate the counter-party's creditworthiness, to consider the counter-party's strength and its ability to perform on its obligation.[279] The guidelines also require the bank to determine the character and financial sophistication of its counter-party. The bank must also ensure that the counter-party understands the risk associated with the derivatives transaction.[280] If the counter-party is unsophisticated, the bank should do what is necessary to ensure that the counter-party understands the risks associated with the transaction.[281] While the guidelines require the bank to ensure that the counter-party understands the risks associated with the transaction, the guidelines emphasize that counter-parties are ultimately responsible for the transactions that they choose to enter.[282]

Additionally, the Fed has implemented specific guidelines applicable to Bankers Trust that it must follow when engaging in leveraged derivatives transactions with counter-parties.[283] These guidelines were implemented as a result of an enforcement action brought by the Fed against Bankers Trust in connection with Bankers Trust's sale of derivatives to Gibson Greetings.[284] The Federal Reserve Bank of New York and Bankers Trust entered into a written agreement regarding BT's leveraged derivative business, under which Bankers Trust agreed that it would conduct its leveraged derivatives transactions ("LDT") in such a manner to ensure that clients engaging in such transactions understand the nature and material terms, conditions, and risks associated with a LDT.[285] The agreement requires Bankers Trust to ensure that the LDT are appropriate for those customers choosing to enter into the LDT.[286] The agreement requires Bankers Trust to make the necessary disclosures to its customers that provide them with sufficient information to understand the nature and material terms, conditions, and risks associated with the agreed upon transaction.[287]

279. *See generally* Banking Organizations, *supra* note 278.

280. *See id.*

281. *See id.*

282. *See id.*

283. Written Agreement By and Among Bankers Trust New York Corp. et al. and Federal Reserve Bank of New York, *available in* 1994 WL 736368, (F.R.B.) (Dec. 4, 1994).

284. *See id.*

285. *See id.* at *2.

286. *See id.*

287. *See id.*

IV. A REJECTION OF THE SUITABILITY RULE IN OTC DERIVATIVES CONTRACTS

A review of the regulatory schemes that govern OTC derivatives dealers reveals the limited context in which dealers are subject to suitability rules. Only in the securities context have regulators adopted suitability rules that shift the responsibility of making inappropriate investment decisions from the customer to the dealer. Outside of the securities context, investors are required to independently assess the suitability of the derivatives transactions they enter.

Security regulators originally adopted suitability rules to protect retail customers against inappropriate sales practices, such as boiler-room sales tactics and churning.[288] Derivatives trading almost always involves institutional customers who are either sophisticated traders or who have the financial capacity to obtain their own investment advice to assist them in their trades.[289] These types of customers are not likely to be victims of boiler-room sales tactics or churning. Unlike retail securities customers who often relinquish control of their securities accounts to their brokers, institutional customers come to the negotiating table with the opportunity to customize the derivatives contract according to their needs. They must maximize this opportunity by ensuring that they fully understand the risks associated with the transaction.[290]

Moreover, the relationship between a derivatives dealer and an end-user should not be compared to the relationship between a broker-dealer and its customer. Broker-dealers, in many instances, have discretionary authority over their clients securities accounts that allow broker-dealers to make trading decisions on behalf of their customers. Because of the relationship that exists between a broker-dealer and its customer, customers in varying degrees, rely upon or expect that their broker will give sound investment advice.

In contrast, the relationship between derivatives dealers and end-users is not an advisory relationship. Derivatives trades between a dealer and end-user should be viewed as being transacted on a

288. *See* Mundheim, *supra* note 11, at 456-58.

289. In her statement before the U.S. House of Representatives Committee on Agriculture's Subcommittee on Risk Management and Specialty Crops, Susan M. Phillips, a member of the Board of Governors of the Federal Reserve System, testified that "[b]y way of background, in the case of banks, investigations by our staff and staff of the other banking agencies indicate that currently there is very little, if any, marketing of derivative contracts to retail investors." 83 Fed. Res. Bull. 497, 499 (1997).

290. *See* Goldman, *supra* note 5, at 1146 n.204.

principal-to-principal basis.[291] A derivatives dealer is a principal to the derivatives contract because it transacts business on behalf of its own account, unlike a broker, who transacts business on behalf of its customer.[292] As a principal to the transaction, the derivatives dealer assumes the risks associated with the trade, just as the end-user assumes the attendant risks. Further, in derivatives transactions, the dealer and end-user are both referred to as counter-parties, a title which suggests that both parties are at counter-positions, transacting business at arm's length.

A. Market Efficiency

Imposing retail-fashioned suitability obligations on derivatives dealers effectively shifts the responsibility of making inappropriate investment decisions from the end-user to the dealer. Such a shift of responsibility affects the efficiency of the derivatives market. Counter-parties enter into derivatives transactions for various reasons, but essentially derivatives instruments provide a means for parties to transfer the risk associated with some underlying. In order for an effective transfer of that risk, both parties must assume the risks associated with the derivatives transaction.[293]

The imposition of suitability obligations creates a one-sided approach that overly burdens derivatives dealers with additional responsibilities and duties.[294] In many instances the added

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291. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1286 (S.D. Ohio 1996) (finding that as counter-parties, Bankers Trust, the derivatives dealer, and Procter & Gamble, were principals in a swap agreement entered into by the parties); *see also* State v. Morgan Stanley & Co., 459 S.E.2d 906, 913 (W. Va. 1995) (finding that as a counter-party in a derivatives transaction, Morgan Stanley, a derivatives dealer, was a "principal in the transactions at stake, not a broker").

292 *See Morgan Stanley Co.*, 459 S.E.2d at 911. A fiduciary relationship should be found to exist between a dealer and end-user only if the course of dealings between the two parties justify the end-user placing trust and confidence in the dealer who has exerted influence over the customer's trading decisions. *See generally id.* (explaining that while the general rule does not place a fiduciary duty on dealers, in some situations where there does exist a certain degree of trust, such a fiduciary duty will be imposed on the dealers).

293 At a Congressional hearing concerning derivatives, Federal Reserve Board Chairman Alan Greenspan testified that "[t]he burden of being informed in the marketplace, especially a wholesale marketplace, must not fall only on the dealer . . . . [D]erivatives increase economic efficiency by allowing the transfer of risk to those willing to bear it. For the transfer of risk to be effective and the efficiency to be realized, end-users must retain ultimate responsibility for transactions they choose to make. In a wholesale market, sophisticated and unsophisticated end-users alike must ensure that they fully understand the risks attendant to any transaction they enter." *See* Goldman, *supra* note 5, at 1146 n.204.

294 *See* Roger D. Blanc, *Securities Markets, Policy Issues Presented By Derivatives Trading*, 8 INSIGHTS 10, 13-14 (1994).

responsibilities could be overwhelming, given the complexity of derivatives transactions. Imposing suitability rules on derivatives dealers presumably would require the dealer to comply with the suitability standards recently crafted for securities transactions involving institutional customers.[295] Under those suitability standards, the dealer would have the additional responsibility of determining if the counter-party understood the investment risks and whether the counter-party used its own independent judgment in entering into the derivatives transaction. If the dealer determines that the counter-party was not capable of understanding the investment risks or did not use its own independent judgment, then the dealer has the additional responsibility of assessing the suitability of the transaction.

In assessing suitability under NASD suitability standards, the dealer might be required to obtain information about the customer's financial and tax status, investment objectives and any other information considered reasonable and necessary to make a recommendation to a customer. With an institutional customer, such as a multinational corporation, the task of reviewing and analyzing the customer's financial information could be insurmountable. In some instances, the dealer might need to hire its own independent analyst to review the information obtained to ensure an accurate evaluation of suitability.

These additional responsibilities and duties would force the dealer to transact business at much higher costs. Further, the responsibilities and duties would inhibit the dealer's ability to offer discounted transactions services in certain widely used types of derivatives instruments, such as plain vanilla swap agreements, because of cost concerns.[296] The establishment of discounted transactions services could provide greater transparency in the derivatives market by making price quotes on swap agreements much more available.[297] Greater transparency in the derivatives market would assist all end-users by providing them with more information about the value of derivatives instruments.[298] Unfortunately, the imposition of suitability obligations prevents brokers from providing such services because of cost concerns.[299] Thus, suitability rules would not only injure end-users, but also would ultimately affect the efficiency and effectiveness of the derivatives market.

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295 *See* 61 Fed. Reg. at 44,100.

296 *See* TREASURY MANAGER'S REPORT, *supra* note 6, at 125-26.

297. *See id.*

298. *See id.*

299. *See id.*

B. OTC Derivatives Contracts as Arms Length Transactions

Instead of imposing suitability obligations on derivatives dealers, the legal relationship between a derivatives dealer and its counter-party should be viewed as an arm's length relationship.[300] In an arm's length transaction, parties negotiate the terms and conditions of the contract with the understanding that each party must watch out for its own interest. The nature of the relationship that exists between the derivatives dealer and end-user requires that both parties protect its own financial interest. Like a car salesperson, the derivatives dealer provides the buyer with advice that is tainted by the dealer's self interest. Accordingly, the buyer must recognize that the derivatives transaction is at arm's length and must make its own suitability assessment.

Even federal regulators endorse the view that OTC derivatives contracts are entered into by counter-parties at arm's length.[301] The Derivatives Policy Group, a group comprised of six broker-dealers with affiliates that are major OTC derivatives market participants, released a report addressing areas concerning derivatives transactions entitled Framework for Voluntary Oversight (the "Framework").[302] The Framework was coordinated with the support of the SEC and CFTC.[303] The Framework provides a voluntary framework for those dealers trading derivatives in unregistered affiliates of SEC-registered broker-dealers and CFTC-registered FCMs.[304] In the area of counter-

300. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F.Supp. 1270, 1286 (S.D. Ohio 1996) (stating that in a swap agreement between Procter & Gamble and Bankers Trust, Bankers Trust dealt with Procter & Gamble at arm's length).

301. *See* TREASURY MANAGER'S REPORT, *supra* note 6, at 1. At a conference sponsored by ISDA attended by regulators, economists and accountants opined that derivatives buyers and sellers are engaged in an arm's length commercial transaction, not an advisory relationship that requires the dealer to disclose all potential risk of a transaction to a buyer. *See id.*

302. *See* Derivatives Policy Group, Framework for Voluntary Oversight (Mar. 1995) (on file with the author) [hereinafter DPG Framework]. The Framework addresses: (1) management control which consists of the implementation of internal management controls; (2) enhance reporting that consists of the periodic submission to the SEC and CFTC of a series of new quantitative reports covering credit risk; (3) exposures arising from OTC derivatives activities and related information; (4) evaluation of risk in relation to capital which consists of the development of a framework for estimating market and credit risk exposures arising from OTC derivatives activities; and (5) counter-party relationships that consist of guidelines for professional intermediaries with respect to their relationship with nonprofessionals counter-parties in connection with OTC derivatives transactions. *See id.* at 3.

303. *See id.* at 1.

304. The Framework applies to OTC products that are interest rate, currency, equity and commodity swaps, and OTC options, including caps, floors, collars, and currency

party relationships, the Framework explicitly states that "OTC derivatives transactions are predominantly arm's length transactions in which each counter-party has a responsibility to review and evaluate the terms and conditions, and the potential risks and benefits, of [the] prospective transaction . . . ."[305]

Like the SEC and CFTC, the Fed also endorses the view that OTC derivatives contracts are arm's length transactions through its support of "Principles and Practices for Wholesale Financial Market Transactions" ("Principles"), which provides a voluntary framework for defining the relationship between participants in the OTC financial markets.[306] Under the coordination of the Federal Reserve Bank of New York, representatives from various trade groups prepared the Principles.[307] The Principles, like the Framework, affirm the arm's-length nature of OTC financial market transactions and encourage each participant to seek independent financial advice.[308] However, the Principles allow parties to enter into a written agreement defining the advisory nature of the relationship whenever a participant is unwilling or unable to take responsibility for its own decisions relating to OTC or financial market transactions.[309]

Courts also endorse the arm's length nature of OTC derivatives contracts.[310] In *Procter & Gamble Co. v. Bankers Trust Co.*, Procter

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forwards, but does not apply to synthetics instruments. *See id.* at 3. The Framework is applicable as long as: (1) the broker-dealer is not subject to the supervisory oversight with respect to capital; (2) the broker-dealer is primarily engaged in the business of holding itself out to unaffiliated counter-parties as a professional intermediary willing to structure and enter into either side of an OTC derivative transaction as a principal; and (3) the broker-dealer's OTC derivative activities are likely to have a material impact, directly or indirectly, on its SEC registered broker dealer affiliate. *See id.*

305. *Id.* at 37.

306. *See* Ernest T. Patrikis et al., *Derivatives Activities of Banking Organizations: Initiatives for Supervision and Enhanced Disclosure, in* Managing Risk Exposure in Derivatives 1995, at 373, 375 (PLI Corporate Law & Practice Course Handbook Series No. B4-7116, 1995).

307. A drafting committee consisting of the Emerging Markets Traders Association, the Foreign Exchange Committee of the Federal Reserve Board of New York, the ISDA, the New York Clearinghouse Association, the Public Securities Association, and the Securities Industry Association developed the Principles over a 13 month period. *See id.* at 381.

308. *See id.* at 378.

309. *See id.*

310. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F.Supp. 1270, 1286 (S.D. Ohio 1996) (finding that as counter-parties, Bankers Trust, the derivatives dealer, and Procter & Gamble were at arm's length); *see also* State v. Morgan Stanley & Co., 459 S.E.2d 906, 913 (W. Va. 1995) (finding that as a counter-party in a derivatives transaction, Morgan Stanley, a derivatives dealers, was a "principal in the transactions at stake, not a broker").

& Gamble contended that advertisements and representations made in connection with the sale and offer of the derivatives contracts were promises that Bankers Trust would use its expertise on behalf of its client to advise Procter & Gamble about the transactions that it entered.[311] The court rejected Procter & Gamble's contention, finding instead that Bankers Trust and Procter & Gamble, as counter-parties, were principals in a bilateral contract.[312] The court held that Bankers Trust dealt with Procter & Gamble at arm's length, and that, Bankers Trust was not acting for or on behalf of Procter & Gamble, but rather as a principal and not a broker in the derivatives transaction.[313]

Viewing OTC derivatives transactions as arm's length transactions should not mean that derivatives dealers have no obligations to their counter-parties.[314] Derivatives dealers should have the primary responsibility for clarifying to its counter-party that their relationship is at arm's length.[315] In fact, many banking organizations engaged in derivatives trading assume the responsibility of clarifying to their counter-parties that an advisory relationship does not exist between the parties.[316] These banking organizations inform their counter-parties that they should assume responsibility for the transactions into which they choose to enter.[317] The Framework also contains provisions stating that the derivatives dealers should use written agreements clarifying the nature of the relationship with the end-user.[318] The Framework also states that dealers should consider providing end-

311. *See Procter & Gamble Co.*, 925 F.Supp. at 1286.

312. *See id.*

313. *See id.*

314. *See id.* at 1286, 1289-91. The court noted that although parties were at arm's length, Procter & Gamble had the duty to disclose vital information and to refrain from making material misrepresentations. *See id.* at 1289.

315. In a September 17, 1995 speech at Berkeley Program in Finance, Hass School of Business, University of California, Berkeley, SEC Commissioner Steven M.H. Wallman stated that counter-parties should clarify the nature of their relationship and the dealer should have the initial responsibility. *See* Conrad G. Bahlke & Junling Ma, *Derivatives: Suitability Issues for Banks and Bank Affiliates*, 12 REV. OF BANKING AND FIN. SERV. 187, 196 n.30 (1996). He stated that after the parties have clarified the nature of the relationship, the end-user should proceed with the derivatives transaction based on its own expertise, with the independent advice of a financial adviser or with an advisory relationship with the dealer. *See id.*

316. *See id.*

317. *See id.*; *see also* DPG Framework, *supra* note 302, at 37.

318. DPG Framework, *supra* note 302, at 39. The guidelines state that where the terms of the OTC derivatives transaction are not reflected in a writing, a professional intermediary should exercise particular care to assure that it has reached a common understanding with its nonprofessional counter-party as to the material economic terms of the transaction. *See id.* at 39-40.

users with disclosure statements that generally identify the principal risks associated with OTC derivatives transactions.[319]

Derivatives dealers should also have an obligation to act in good faith in connection with their derivatives dealings with counter-parties. The Framework specifically requires dealers to act in good faith in formulating a specific OTC derivative transaction requested by an end-user.[320] Furthermore, the Framework also states that if an end-user requests the assistance of a dealer to evaluate an OTC derivatives transaction involving either a payment formula or a significant leverage component, the dealer should offer to provide additional information or should recommend that the counter-party obtain independent professional assistance.[321]

V. POLICY DISCUSSION

Recent counter-party losses in the OTC derivatives market have become a major public policy concern. Most counter-party losses result from insolvencies of contract counter-parties, inappropriate investment decisions, or fraudulent sales practices.[322] These losses receive a substantial amount of governmental attention primarily because counter-party losses can lead to systemic loss.[323] Systemic loss involves the possibility that the failure of a major participant in the derivatives market could cause widespread losses at another firm or cause disruptions in other market segments or in the entire financial system.[324] Given the global nature of the derivatives market, systemic loss could result in a financial disruption that could have international implications.

Many have called for the imposition of suitability rules to address the problem of counter-party losses. However, it is not apparent that the imposition of such rules will eliminate counter-party losses. It is apparent, however, that the imposition of suitability rules will affect the efficiency of the derivatives market. Any measures implemented to

319. *See id.* at 38.

320. *See id.*

321. *See id.*

322. Susan M. Phillips, Member of the Federal Reserve Board of Governors stated that "[m]ost, perhaps all, would agree that the objectives of public policy in this area are to ensure the integrity of commodity markets, especially deterring market manipulation, and to protect market participants from losses resulting from fraud or the insolvency of contract counter-parties." Susan M. Phillips, Address before the Subcommittee on Risk Management and Specialty Crops of the Committee on Agriculture, U.S. House of Representatives (Apr. 15, 1997), *in* 83 Fed. Res. Bull. 1, 497 (1997).

323. *See* Blanc, *supra* note 294, at 14.

324. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 61.

address counter-party losses should take into consideration the need to ensure the efficiency and effectiveness of the derivatives market. The imposition of retail-fashioned suitability rules stymies the efficiency of the market by unduly burdening derivatives dealers with additional responsibilities that run contrary to the risk-shifting principles that fuel the derivatives market.

To encourage the efficiency and effectiveness of the derivatives market, and also prevent counter-party losses, greater emphasis should be placed on the counter-parties' responsibility to understand fully and to manage effectively the derivatives transactions they enter. By emphasizing both parties' responsibility to implement internal controls to manage their derivatives trading, each counter-party assumes responsibility for its own derivatives transactions.[325] This approach does not unduly burden either party, and allows the market to operate efficiently.

A. Market Discipline

Recognizing the power of market forces is an effective way to achieve the underscored policy objectives without affecting the efficiency of the derivatives market.[326] Every financial market, whether or not subject to governmental regulation, has some component of market discipline, that stems from market participants protecting their interest and dealers competing for end-users' business.[327] That market discipline involves both parties making informed decisions about the derivatives transactions into which they enter in order to protect their own financial interest.[328]

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325. *See Chief Urges Internal Controls*, *supra* note 17 (reporting that SEC Chairman Arthur Levitt stated that "[a] system of sound internal controls is the first line of defense against misuse of derivatives . . . [y]ou can't address fast changing instruments with ironclad regulations . . . the typical derivatives loss is less a failure of regulation, than a failure of oversight by the parties involved").

326. The GROUP OF THIRTY REPORT underscores the need of all market participants, including end-users, to assume responsibility for their derivatives trading. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 7-24. The Report rejects the idea of pervasive regulation of the derivatives market, and instead specifically focuses on the need for effective management and internal controls of the parties that invest in derivatives. *See id.* Rather than placing the responsibility of derivatives trading on the dealers, the GROUP OF THIRTY REPORT heavily emphasizes that the market participants, whether dealer or end-user, must assess its own financial condition, and implement effective internal controls to manage the risk associated with derivatives trading. *See id.*

327. Federal Reserve Board Chairman Alan Greenspan stated, "it is critically important to recognize that no market is ever truly unregulated. The self-interest of market participants generates private market regulation." Greenspan, *supra* note 22.

328. SEC Chairman Arthur Levitt testified that market discipline in the OTC

Market discipline in the derivatives market begins by counter-parties implementing internal controls that designate qualified persons to trade derivatives and monitor the transactions.[329] A major issue in several of the derivatives losses involved the inadequacy of internal controls to monitor the derivatives transactions.[330] In fact, the collapse of Barings Bank resulting from $1.4 billion in derivatives losses occurred due to a lack of effective internal controls that allowed a rogue trader to engage in unauthorized trading in derivatives without being detected.[331] While various problems existed at Barings Bank that permitted the unauthorized trading, one problem was the lack of separation of management duties.[332] The trader had responsibility for front- and back-office management, which allowed him to conceal his unauthorized trading by providing his supervisors with false trading reports.[333] A basic principle of internal controls in a dealer setting is to separate the responsibility for front- and back-office management.[334]

Market participants must also implement effective systems to manage risks associated with derivatives trading.[335] With respect to market risk, mechanisms should be established to measure and to protect against unacceptable risk levels. To measure market risk, market participants can engage in certain valuation techniques, such as subjecting derivatives positions to mark-to-market valuations on a

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derivatives market demands a high degree of credit worthiness and sophistication among the OTC derivatives dealers. *See Testimony before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce* (May 24, 1994) (statement of Arthur Levitt, SEC Chairman), *available in* WESTLAW, Allnewsplus Library, Congress Testimony File, 1995 WL 13415675.

329. *See* Blanc, *supra* note 294, at 10-11.

330. *See* Jeffrey Taylor, *CFTC Levies Fines Against German Firm*, WALL ST. J., July 28, 1995, at C1 (reporting that in connection with a $2.2 million fine assessed against Metallgesellschaft AG for a $1 billion derivative loss that brought the company to the brink of insolvency, then CFTC Chairwoman Schapiro stated "I think the most important point is the focus on the lack of internal controls throughout the organization . . . . We hope this [fine assessment] will teach multinational corporations that they must have adequate internal controls."); *see also* Miller, *Air Products Takes a Charge of $60 Million*, WALL ST. J., May 12, 1994, at A3 (reporting that the company recognized that it needed to focus on its internal controls as a means of avoiding inappropriate speculation in the future).

331. *See* McKown & Purcell, *supra* note 208, at 123.

332. *See id.*

333. *See id.*

334. *See id.*; *see also* Kurt Eichenwald, *Learning the Hard Way How to Monitor Trades*, N.Y. TIMES, Mar. 9, 1995, at D1 (providing a discussion about the importance of checks and balances for traders).

335. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 43-49.

frequent basis.[336] Participants can also develop pricing models to monitor the value of their derivatives' positions.[337] The lack of transparency in the derivative market demands that counter-parties consistently monitor the value of their derivatives' position to determine how changes in underlying prices and rates have impacted their derivatives position.[338] To protect against adverse market movements, counter-parties can also hedge their derivatives' positions to reduce losses.[339] Techniques such as delta hedging, which involves the constant readjustment of the hedge and the derivative to preserve a desired level of risk, have been used by derivatives dealers and end-users to manage market risk.[340]

End-users can effectively manage credit risk by entering into transactions only with derivatives dealers with triple A credit ratings.[341] Many major derivatives dealers create DPCs, which are well-capitalized subsidiaries with triple A ratings, that purport to remain solvent even if its parent company becomes insolvent.[342] Both end-users and dealers can also use netting arrangements to reduce credit risk.[343] Such arrangements allow both the end-user and dealer to combine their payment obligations arising from multiple transactions into one net payment.[344] Upon a default by a counter-party, the netting arrangement only obliges the party to make one payment.

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336. *See id.* at 9.

337. *See* Kojima, *supra* note 9, at 276 (discussing the use of pricing models in handling market rise); *see also* DPG Framework, *supra* note 302, at 20 (indicating that the Framework provides for various valuations systems that dealers can use to measure market risk). The same types of techniques can be used by end-users. In fact, the Group of Thirty Report recommends end-users to employ those techniques used by derivatives dealers. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 8.

338. *See* Kojima, *supra* note 9, at 276; *see also* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 9. The Group of Thirty Report recommends that counter-parties mark their derivatives positions to market on at least a daily basis of risk management purposes. *See id.*

339. *See* Kojima, *supra* note 9, at 276; *see also* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 45-46.

340. *See* Kojima, *supra* note 9, at 276.

341. *See* DERIVATIVES AND SYNTHETICS, *supra* note 51, at 332.

342. *See id.*

343. *See* GROUP OF THIRTY, GLOBAL DERIVATIVES STUDY GROUP, *supra* note 33, at 22. The Report states that netting of contractual payments in the event of a counter-party's default is the most important means of mitigating credit risk. *See id.*

344. *See id.*

B. Legal Recourse

The judicial system also provides a forum for counter-parties to seek redress for losses resulting from fraudulent sales practices.[345] Legal actions not only serve as a means of preventing fraudulent sales practices but also make other derivatives dealers more conscientious when engaging in derivatives trades with end-users.[346] In cases involving fraudulent sales practices in connection with the offer and sale of derivatives instruments, end-users obtained redress either by using the judicial system or by negotiating a settlement with the derivatives dealer.[347] Moreover, federal agencies bring actions against various derivative dealers for fraudulent sale practices involving derivatives transactions.[348]

VI. CONCLUSION

The imposition of suitability rules on derivatives dealers as a means of preventing counter-party losses is inappropriate. Counter-parties in OTC derivatives transactions engage in the transactions on a principal-to-principal basis. End-users must assume responsibility for the risks associated with their transactions, instead of seeking to shift the responsibility for inappropriate investment decisions to the derivatives dealers. End-users trading derivatives are institutional customers with varying degrees of sophistication regarding the derivatives market. To the extent that such traders do not understand the derivatives transactions into which they choose to enter, the investor has the responsibility to obtain its own independent financial advice to assist the investor in the transaction.

The dealer should not be obliged to determine suitability for an institutional investor that comes to the bargaining table with the opportunity to negotiate the transaction consistent with its financial condition. The investor is much more capable of determining whether a transaction is suitable in light of its financial condition. The investor,

345. *See supra* note 3.

346. Federal Reserve Board Chairman Alan Greenspan stated that "[i]nstitutional participants in the off-exchange derivatives market also have demonstrated their ability to protect themselves from losses from fraud and counter-party insolvencies . . . . When dealers have engaged in deceptive practices, their victims have been able to obtain restitution by going to court or simply threatening to do so. The threat of legal damages provides dealers with incentives to avoid misconduct. A far more powerful incentive is the fear of loss of the dealer's good reputation, without which it cannot compete effectively." Greenspan, *supra* note 22.

347. See *supra* Part III.A.2.d of this Article discussing common-law fraud cases brought by end-users against derivatives dealers.

348. *See supra* Part III.A.3.

not the dealer, has better insight about its financial needs and how certain investments will impact its financial portfolio. Moreover, the imposition of suitability rules overly burdens the dealer with additional duties and responsibilities, without requiring the end-user to be responsible for its derivatives transactions.

The additional responsibilities associated with suitability obligations require dealers to transact derivatives business at higher costs. These costs are transferred to all end-users and ultimately stymie the growth of the derivatives market. A much more effective means of preventing counter-party losses that insures the growth of the market is to classify counter-parties relationships as arm's length relationships. Viewing derivatives transactions in such a manner encourages counter-parties to implement effective internal controls to ensure that they understand fully and manage effectively their derivatives transactions. Effective management of derivatives transactions will substantially prevent counter-party losses resulting from inappropriate investment decisions and contract counter-party insolvencies. Moreover, the implementation of effective management systems improves the health of the derivatives market and encourages its growth.

Family Business Legal & Financial Advisor Conference

In the pursuit of academic excellence, the Loyola University Chicago Law Journal has maintained a strong position in the forefront of legal developments affecting the practice of law. In light of Schirmer v. Bear and the new section 12.56 of the Illinois Business Corporation Act, we have devoted a part of this Issue to the impact of these developments on the operations of family held enterprises in Illinois. We remain grateful to the Loyola Corporate Law Center and the School of Business for their sponsorship and participation in the Family Business Legal & Financial Advisor Conference held at Loyola University Chicago on November 11, 1997. While the Conference participants discussed the issues of management and operations of family businesses from various perspectives, we chose to focus only on the legal aspects of operating a family business in the aftermath of the recent changes in Illinois law. We believe that the following two articles will illustrate the magnitude of these changes.

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