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Broker-Dealer Sales Practice in Derivatives Transactions: A Survey and Evaluation of Suitability Requirements

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Broker-Dealer Sales Practice in Derivatives Transactions: A Survey and Evaluation of Suitability Requirements

Daniel G. Schmedlen, Jr.*

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"[T]hese guys have done some pretty wild stuff. And you know, they probably do not understand it quite as well as they should. I think that they have a pretty good understanding of it, but not perfect. And that's like perfect for us."¹

I. Introduction

A derivative financial instrument (derivative) is a bilateral contract that is linked to, or derives its value from, the value of an underlying security, index, or reference rate.² The derivative securities industry has "boomed" in the past two years.³ Merrill Lynch & Co., the nation's largest brokerage firm, experienced a fifty-seven percent increase in derivatives trading revenue from 1992 to 1993.⁴ The notional value⁵ of all derivatives contracts entered into by United States-based commercial banks increased from \$11.8 trillion at the end of 1993 to over \$15.5 trillion in September of 1994.⁶

Enthusiasm about derivatives, however, has turned to paranoia because of recent staggering losses sustained by derivatives end-users.⁷ In December

1. BT Securities Corp., Securities Act Release No. 7,124, Exchange Act Release No. 35,136, Fed. Sec. L. Rep. (CCH) ¶ 85,477 (Dec. 22, 1994) (quoting derivatives dealer's comments regarding unsophisticated customer).

2. See *infra* note 25 and accompanying text (defining derivative financial instrument).

3. See Nicholas Bray, *Two Agencies Issue Guidelines on Derivatives*, WALL ST. J., July 27, 1994, at A6 (describing derivatives market as "booming").

4. Michael Siconolfi, *Merrill Lynch Says Derivatives Revenue Swelled 57% to \$761 Million Last Year*, WALL ST. J., Mar. 17, 1994, at A10.

5. The "notional amount" in a derivatives transaction is the amount of the underlying asset. See GAO REPORT, *infra* note 16, at 28 n.7 (explaining notional amounts in derivatives transactions). Regulators aggregate the notional amount of each derivatives transaction to determine trends in the derivatives markets. *Id.* at 28. In a swap agreement, parties calculate their obligations by multiplying the value of the underlying security, index, or reference rate (for example, an interest rate) by the notional amount (for example, \$10 million). Telephone Interview with Merrill Lynch & Co. (Feb. 23, 1995); see also *infra* note 31 (explaining swap agreements). Generally, parties do not exchange the notional amount in a swap. GAO REPORT, *infra* note 16, at 28 n.7. For forwards, futures, and options, regulators use the amount of the contract as the notional value for measuring the volume of each contract. *Id.*, see also *infra* note 27 (explaining forwards, futures, and options).

6. OFFICE OF THE COMPTROLLER OF THE CURRENCY, 3D QUARTER 1994 CALL REPORT ON DERIVATIVES ACTIVITIES OF UNITED STATES COMMERCIAL BANKS (Feb. 8, 1995) (on file with the Capital Markets Division of the Office of the Comptroller of the Currency).

7. In the derivatives market, end-users are market participants that enter into derivatives transactions for their own accounts. See *infra* note 44 and accompanying text (defining end-users). End-users use derivatives to manage risks, to speculate on market movements, to obtain better financing terms, and to diversify their investment portfolios. See *infra* notes

1993, a New York unit of Metallgesellschaft AG, a German company, reported a loss of over \$1 billion resulting from trading in oil-based derivatives.⁸ In April 1994, Proctor & Gamble Co. (P&G) disclosed that P&G would take a \$157 million charge to cover interest rate derivatives losses sustained over a period of less than two months.⁹ In the aftermath of P&G's announcement, Commissioner Richard Roberts of the Securities and Exchange Commission (SEC) correctly predicted that more companies would soon reveal losses attributable to derivatives trading.¹⁰ Indeed, by the end of 1994, several mutual funds, municipalities (most notably Orange County, California), and companies had announced losses, some of them staggering, that resulted from derivatives transactions.¹¹ By August 1994, derivatives trading had accounted for nearly \$6.4 billion in losses since 1993.¹²

A number of end-users that suffered large losses due to derivatives transactions filed suit against the dealers that sold them the derivatives.¹³

48-52 and accompanying text (describing ways in which end-users use derivatives).

8. Bray, *supra* note 3, at A6.

9. Gabriella Stern & Steve Lipin, *Proctor & Gamble to Take a Charge to Close Out Two Interest-Rate Swaps*, WALL ST. J., Apr. 13, 1994, at A3.

10. *Roberts Sees More Losses From Derivatives Trading*, WALL ST. J., Apr. 29, 1994, at C1.

11. See Karen Slater Damato, *Examining Your Mutual Funds for Derivatives Risk*, WALL ST. J., Aug. 11, 1994, at C1 (listing mutual funds that suffered heavy losses in derivatives); G. Bruce Knecht, *I Owe U.. How a Texas College Mortgaged its Future in Derivatives Debacle*, WALL ST. J., Sept. 23, 1994, at A1 (explaining how college's investment portfolio lost half its value over nine month period due to decrease in value of derivatives); 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 suffered \$700 million in losses due to decrease in value of derivatives); James P. Miller, *Air Products Takes a Charge of \$60 Million*, WALL ST. J., May 12, 1994, at A3 (reporting that Air Products & Chemicals Inc. took \$60 million charge to reflect declining value of derivatives); *Orange County Crisis — Local Heroes: Public Finance Chiefs Are Very Often Boring; That's the Good News*, WALL ST. J., Dec. 8, 1994, at A1 (reporting that nearly 20 municipalities in Ohio have claimed losses of \$14 million incurred in derivatives transactions).

12. See Randall Smith & Steven Lipin, *Beleaguered Giant: As Derivatives Losses Rise, Industry Fights to Avert Regulation*, WALL ST. J., Aug. 25, 1994, at A1 (reporting losses in derivatives transactions).

13. See Knecht, *supra* note 11, at A1 (reporting that Odessa College sued derivatives dealer to recover \$11 million in derivatives trading losses); Steven Lipin, *Bankers Trust Sued on Derivatives*, WALL ST. J., Sept. 13, 1994, at C1 (reporting that Gibson Greetings Inc. sued derivatives dealer to recover \$23 million in derivatives trading losses); Paulette Thomas, *Proctor & Gamble Sues Bankers Trust Because of Huge Losses on Derivatives*, WALL ST. J., Oct. 28, 1994, at A6 (reporting that Proctor & Gamble Co. sued derivatives dealer to recover

The end-users claimed that they had not understood what they were buying and accused the dealers of taking advantage of the end-users' ignorance.¹⁴ In November 1994, one such end-user, Gibson Greetings, Inc., settled its suit against BT Securities Corporation, a derivatives dealer, for \$14 million.¹⁵

On May 18, 1994, the General Accounting Office (GAO), in response to a request from Congress, issued a report (GAO Report) on derivatives activity.¹⁶ The GAO Report concluded that current over-the-counter (OTC) derivatives trading practices posed a serious danger to the financial system of the United States and called for formal regulations governing OTC derivatives trading.¹⁷

In response to the heightened concern about insufficient OTC derivatives controls, members of Congress introduced six bills during the first seven months of 1994 that would provide for enhanced supervision of, and limitations on, OTC derivatives trading.¹⁸ The bills propose a wide range

\$130 million in derivatives trading losses).

14. See G. Bruce Knecht, *The Lawyers' Turn: Derivatives Are Going Through Crucial Test: A Wave of Lawsuits*, WALL ST. J., Oct. 28, 1994, at A1 (reporting that customers in derivatives lawsuits alleged that derivatives dealers took advantage of customers' lack of sophistication).

15. See Steven Lipin, *Gibson Greetings Reaches Accord in Suit Against Bankers Trust Over Derivatives*, WALL ST. J., Nov 25, 1994, at A2 (reporting that Gibson Greetings Inc. settled suit with derivatives dealer). Gibson Greetings lost over \$20 million in derivatives transactions recommended by BT Securities Corp. *Id.* The settlement provided that Gibson would have to pay only \$6.2 million of those losses. *Id.*

16. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (1994) [hereinafter GAO REPORT].

17. *Id.* at 123-24.

18. See S. 2291, 103d Cong., 2d Sess. § 3(a) (1994) (limiting FDIC insured institution's ability to purchase, sell, or engage in any transaction involving derivative financial instrument); H.R. 4745, 103d Cong., 2d Sess. § 2 (1994) (providing framework for SEC supervision and regulation of all derivatives activities including counterparty agreements); H.R. 4503, 103d Cong., 2d Sess. § 101 (1994) (calling for establishment of substantially similar oversight guidelines for federally insured financial institutions engaged in transactions involving derivative financial products by federal regulatory agencies and mandating risk evaluation procedures for federally insured financial institutions); S. 2123, 103d Cong., 2d Sess. § 2 (1994) (amending Federal Deposit Insurance Act to prohibit federally insured institutions and their affiliates from engaging in nonhedging transactions involving derivative financial instruments); H.R. 4170, 103d Cong., 2d Sess. § 2 (1994) (providing for delineated disclosure requirements of derivative financial instruments by federally insured financial institutions); H.R. 3748, 103d Cong., 2d Sess. § 101 (1994) (establishing Federal Derivatives Commission to promulgate principles and standards for federal oversight of federally insured financial institutions).

of solutions, ranging from the creation of a Federal Derivatives Commission¹⁹ to a general prohibition forbidding banks from engaging in derivatives transactions that do not qualify as "hedging."²⁰ The 103d Congress, however, never voted on the proposals. Early in 1995, members of the House of Representatives introduced two more bills governing derivatives.²¹

This Note analyzes the state of OTC derivative securities sales practice, including the current regulatory scheme and proposed revisions. Part II of this Note defines derivative financial instruments and describes their associated risks and benefits.²² Part III examines the current regulatory framework governing broker-dealer sales practice in OTC derivatives transactions and analyzes the GAO Report and pending legislation providing for stricter regulation.²³ Part IV evaluates the present and proposed schemes for regulating broker-dealer sales practice in OTC derivatives transactions.²⁴

II. Derivatives Basics

A derivative financial instrument is a bilateral contract that is linked to, or derives its value from, the value of an underlying security, index, or reference rate (an underlying).²⁵ Underlyings can include securities, commodities, indexes, currency rates, and interest rates.²⁶ Every derivatives transaction includes options, forward-based instruments, or a combination of both.²⁷

19. See H.R. 3748, 103d Cong., 2d Sess. § 103 (1994) (proposing establishment of "Federal Derivatives Commission").

20. See S. 2123, 103d Cong., 2d Sess. § 2 (1994) (proposing amendment of Federal Deposit Insurance Act to generally prohibit, with some exceptions, FDIC insured institutions from engaging in any transaction involving derivatives). Hedging is a risk management technique. See *infra* note 48 (defining hedging).

21. See H.R. 20, 104th Cong., 1st Sess. § 101 (1995) (establishing Federal Derivatives Commission to promulgate principles and standards for federal oversight of federally insured financial institutions); H.R. 31, 104th Cong., 1st Sess. §§ 101, 301, 401, 501 (1995) (providing for increased disclosure of derivatives positions by financial institutions, for certain insolvency reforms concerning derivatives, for international regulatory cooperation, and for new study of speculation, margin, and collateral requirements by GAO).

22. See *infra* notes 25-91 and accompanying text (describing derivatives).

23. See *infra* notes 92-208 and accompanying text (examining current and proposed regulatory frameworks for oversight of derivatives).

24. See *infra* notes 209-35 and accompanying text (evaluating current and proposed schemes for regulating derivatives).

25. See GAO REPORT, *supra* note 16, at 24 (defining derivative financial instrument).

26. See *id.* (listing examples of underlying assets in derivative instruments).

27. See GROUP OF THIRTY, *infra* note 62, at 29 (stating that options and forward-based instruments are "building blocks" of all derivatives). An option contract gives the option

Market participants can, and often do, combine simple derivatives, such as options,²⁸ futures,²⁹ and forwards³⁰ to form more complex instruments, such as swaps,³¹ caps, floors, collars,³² and others.³³

holder, in exchange for payment of a premium, the right, but not the obligation, to buy or sell an underlying (or settle the value for cash) at a price, called the strike price, during a time period or on a specific date. *Id.* at 32. Forward-based instruments include both forward contracts and futures contracts. *Id.* at 30, 32. A forward contract is an "over-the-counter" agreement that obligates one counterparty to buy, and the other to sell, a specific underlying at a specific price, amount, and date. *Id.* at 30. Futures are a type of forward-based contract that trade on organized exchanges. *Id.* at 32. Futures differ from forwards in that the terms of a futures contract are standardized, while the terms of a forward contract are not standardized, but instead left to the parties to determine. *Id.* at 30, 32. Exchanges regulate the trading of futures and some option contracts, while market participants negotiate forward contracts and other option contracts privately, that is, over-the-counter. See GAO REPORT, *supra* note 16, at 4-5 (describing ways in which market participants trade derivatives).

28. See *supra* note 27 (discussing options); see generally THE OPTIONS INST., CHICAGO BD. OPTIONS EXCH., OPTIONS: ESSENTIAL CONCEPTS AND TRADING STRATEGIES (1990) (same) [hereinafter THE OPTIONS INST.].

29. See *supra* note 27 (describing futures); see generally TODD LOFTON, GETTING STARTED IN FUTURES (1989) (discussing futures and providing comprehensive bibliography).

30. See *supra* note 27 (describing forward contracts).

31. See GROUP OF THIRTY, *infra* note 62, at 31 (describing swaps). A swap transaction is an over-the-counter bilateral agreement obligating two parties to exchange a series of payments at specified intervals known as settlement dates. *Id.* Parties either fix the payments of a swap or, more commonly, calculate the payments for each settlement date by multiplying the quantity of the underlying (the notional amount) by specified reference rates or prices. *Id.* Each party to a swap makes payments calculated by a different formula. *Id.* Parties generally net interim payments, with one party paying the difference to the other. *Id.* In simplest terms, a swap is a series of forward contracts. *Id.*

32. See *id.* at 33 (describing caps, floors, and collars). Like a swap, a cap transaction entails a series of periodic payments. *Id.* The buyer of a cap instrument pays a premium to the seller and at each payment date, receives from the seller a payment equal to the difference, if positive, between a reference rate (which is variable) and a strike rate ("cap") multiplied by a notional amount. *Id.* A floating-rate borrower might use a cap to protect against a rise in interest rates. *Id.* A floor contract is the opposite of a cap in that the seller must pay the buyer only if the difference between the reference rate and the strike rate (here, the "floor") is negative. *Id.* Therefore, a floor protects a floating-rate investor against a decline in interest rates. *Id.* Buying a collar is equivalent to buying a cap and selling a floor. *Id.*

33. See *id.* at 30-34 (describing complex derivatives). Other types of complex derivatives include "swaptions" (options on swaps) and options on futures contracts. See *id.* at 33-34 (describing swaptions and futures options). Some market participants include within the definition of derivatives a wide variety of debt instruments that have pay-off characteristics reflecting embedded derivatives (for example, "structured notes"), or have option characteristics, or are created by "stripping" particular components of other instruments such as principal or interest payments. See *id.* at 29 (describing financial instruments that might meet the definition of "derivative").

As with any contract, each derivatives transaction involves at least, and usually no more than, two parties, called counterparties.³⁴ In addition, a derivatives contract obligates both counterparties to undertake some performance.³⁵ In a transaction involving an exchange-traded derivative, the central exchange is a counterparty³⁶

Participants in the derivatives market fall into two distinct categories: broker-dealers (dealers) and end-users.³⁷ Dealers act in two capacities. First, dealers sell derivatives contracts involving other counterparties.³⁸ For example, a dealer might sell to a client a derivative instrument to which the Federal Home Mortgage Association is a counterparty³⁹ Second, dealers offer and enter into derivatives transactions in which the dealers themselves are counterparties.⁴⁰ For example, swaps dealers commonly quote bids and offers at which they are willing to enter into swaps as a counterparty⁴¹ Derivatives dealers include banks, securities firms, insurance companies, and affiliates of each.⁴² Dealers normally profit from derivatives trading by charging fees or earning returns from bid-ask spreads.⁴³

In derivatives transactions, end-users are the counterparties that are not dealers.⁴⁴ End-users can include corporations, financial institutions, govern-

34. See *id.* at 30 (calling parties to derivatives transaction "counterparties").

35. See *supra* notes 27, 31, 32 (describing rights and obligations of participants in various derivatives transactions).

36. See GROUP OF THIRTY, *infra* note 62, at 32 (stating that exchanges are parties to derivatives contracts traded on organized exchanges).

37. See *id.* at 34 (categorizing all derivatives market participants as either dealers or end-users).

38. See *id.* at 41 (explaining dealer's role in brokering derivatives transaction between counterparties).

39. See Telephone Interview with Merrill Lynch & Co. (Feb. 23, 1995) (describing dealer-customer relationships in OTC derivatives market).

40. See GROUP OF THIRTY, *infra* note 62, at 42 (describing evolution of derivatives dealer's role from broker to counterparty).

41. Christopher L. Culp & Robert J. Mackay, *Regulating Derivatives: The Current System and Proposed Changes*, REGULATION, Fall 1994, 38, 39 (describing participants in OTC derivatives markets).

42. See GAO REPORT, *supra* note 16, at 30 (listing types of institutions that act as derivatives dealers).

43. See GROUP OF THIRTY, *infra* note 62, at 42 (describing ways in which dealers profit from derivatives trading). Normally, derivatives dealers structure their asking prices for entering into derivatives transactions to include a margin of profit. *Id.*

44. See *id.* at 34 (stating that derivatives market participants are either dealers or end-users).

ment entities, individual investors, and institutional investors.⁴⁵ Dealers sell derivatives to, and enter into derivatives contracts with, end-users.⁴⁶ Participants in the derivatives market are often both dealers and end-users.⁴⁷

A. Uses of Derivatives

End-users can use derivatives in at least four ways. First, end-users can use derivatives to manage risk by "hedging"⁴⁸ against adverse changes in the values of the underlying assets or other related investments within a portfolio.⁴⁹ Second, end-users can use derivatives to speculate on anticipated changes in the values of the underlying assets.⁵⁰ Third, end-users can use derivatives to obtain better financing terms.⁵¹ Finally, end-users can use derivatives to diversify their investment portfolios.⁵²

45. See GAO REPORT, *supra* note 16, at 29 (listing classes of derivatives market participants that act as end-users).

46. See *supra* notes 39, 41 and accompanying text (describing transactions between dealers and end-users).

47. See GROUP OF THIRTY, *infra* note 62, at 34 (stating that participants in derivatives market may act as both dealer and end-user). *But see* GAO REPORT, *supra* note 16, at 29-30 (implying that participants in derivatives market are either dealers or end-users, but not both).

48. See JOSEPH D. KOZIOL, HEDGING PRINCIPLES, PRACTICES, AND STRATEGIES FOR THE FINANCIAL MARKETS 3 (1990) (defining hedging as process of dynamically managing risks by using "offset mechanism"). For example, if the value of a position decreases by \$100, the offset mechanism (the hedge) should increase in value by \$100. *Id.* Likewise, if a position increases in value by \$500, the value of the hedge should decrease by \$500. *Id.*

49. See *id.* at 4-6 (observing that four basic methods of establishing hedges all involve use of derivatives). Specifically, hedging involves contractual agreements (including swaps), forward contracts, futures contracts, and options contracts. *Id.*

50. See THE OPTIONS INST., *supra* note 28, at 69-82 (describing speculation strategies involving derivatives).

51. See GAO REPORT, *supra* note 16, at 25 (observing that some derivatives enable market participants to obtain better financing terms). Derivatives allow market participants to improve their financing terms by enabling participants to work together to take advantage of differences in the rates and terms under which participants borrow money. *Id.* In addition, derivatives enable participants to more effectively and efficiently hedge their risks, and thereby improve their creditworthiness. *Id.*

52. See James E. Rhodes & Carol W. Proffer, *To Hedge or Not to Hedge? (Parts I & II)*, in MANAGING CURRENCY RISK 4, 5, 10 (Mark P. Kritzman & Katrina F. Sherrerd eds., 1989) (explaining that ability to hedge currency risk encourages investment in foreign markets and that three most commonly used methods of hedging currency risk all involve derivatives). *But see* Fischer Black, *Universal Hedging*, in MANAGING CURRENCY RISK, *supra*, at 28-30 (asserting that because currency rate movements often correlate to market movements, some indirect currency risk is unavoidable notwithstanding use of derivatives).

Investing in some derivatives can be more cost-effective than investing in the underlying assets. For example, an option to buy or sell an underlying asset usually costs a fraction of the price of the underlying asset.⁵³ Because investing in derivatives often involves a great deal of leverage, derivatives can offer investors much higher returns than nonderivative instruments when the market moves in a favorable direction.⁵⁴ The converse, however, also is true. Losses are proportionally much higher when the market moves in an unfavorable direction.⁵⁵

B. Risks Involved in Derivatives Transactions

The risks involved in derivatives trading — market risk,⁵⁶ credit risk,⁵⁷

53. See Lee Berton, *Understanding the Complex World of Derivatives*, WALL ST. J., June 14, 1994, at C1 (observing that option's price is usually small percentage of underlying asset's value).

54. See *id.* (noting that leverage factor in transaction involving option can magnify gains in value of option). For example, suppose that the price of ABC's stock is \$50/share and that the price of a 90-day call option on ABC's stock, with a strike price of \$50, is \$2/option. See Telephone Interview with Merrill Lynch & Co. (Feb. 23, 1995) (explaining leverage in options transactions). An investor, with \$10,000 to invest, expects the price of that stock to rise to \$55/share during the next three months. *Id.* The investor can either buy 200 shares of ABC's stock at \$50/share or 5,000 call options at \$2/option for \$10,000. *Id.* Suppose, as the investor hoped, that the price of ABC's stock rises to \$55/share during the three month period. *Id.* If the investor had purchased 200 shares of stock at \$50/share and sold them at \$55/share, the investor would realize a \$1,000 profit. *Id.* On the other hand, if the investor had purchased 5,000 options at \$2/option and sold the options at market value, the investor would enjoy a \$15,000 profit. *Id.* As the stock's price increases, the value of that stock's call options also rises. *Id.* In this case, the lowest reasonable price of a call option with a strike price of \$50 is \$5 (the stock price, \$55/share, minus the option strike price, \$50). *Id.* Therefore, the investor's 5,000 options would be worth a total of \$25,000, yielding a \$15,000 profit for the investor's initial \$10,000 investment. *Id.* In summary, the investor would achieve a 10% return by investing in ABC's stock, compared with a 150% return by investing the same amount of money in the corresponding call options. *Id.*

55. Telephone Interview with Merrill Lynch & Co. (Feb. 23, 1995). For example, using the fact scenario from note 54, *supra*, if the investor purchased 5,000 options exercisable at \$50/share and the price of ABC's stock fell and remained at \$49/share, the options would be worthless and the investor would lose the entire \$10,000 investment. *Id.* By contrast, if the investor had purchased the actual stock at \$50/share, the investor would lose only \$200, or 2% of the investment. *Id.*

56. See *infra* notes 63-65 and accompanying text (defining and describing market risk in derivatives transactions).

57. See *infra* notes 66-68 and accompanying text (defining and describing credit risk in derivatives transactions).

operational risk,⁵⁸ and legal risk⁵⁹ — are identical to the risks involved in many other traditional financial activities.⁶⁰ Risks associated with derivatives, however, are more difficult to measure.⁶¹ The Group of Thirty, an international financial policy organization composed of representatives of central banks, the financial industry, and academia, described the types of risks involved in derivatives transactions in a 1993 study⁶²

The Group of Thirty's study defined "market risk" as the exposure to a change in the value of a derivative when market conditions change.⁶³ If a derivative is part of a portfolio, the overall exposure of the portfolio determines the market risk.⁶⁴ The GAO Report observed that the many factors that affect market risk make measuring and managing market risk "difficult" and "extremely complicated," especially in cases involving large and diverse portfolios.⁶⁵

58. See *infra* notes 69-70 and accompanying text (defining and describing operational risk in derivatives transactions).

59. See *infra* notes 71-73 and accompanying text (defining and describing legal risk in derivatives transactions).

60. See GAO REPORT, *supra* note 16, at 44 (noting similarity of risks inherent in derivatives and other financial transactions); GROUP OF THIRTY, *infra* note 62, at 43 (same); Culp & Mackay, *supra* note 41, at 6 (same).

61. Telephone Interview with Merrill Lynch & Co. (Jan. 30, 1995); see *infra* notes 65, 68 and accompanying text (describing difficulties in assessing risk in derivatives transactions). Derivatives dealers use sophisticated computer models to value derivatives and predict price trends. Telephone Interview with Merrill Lynch & Co., *supra*.

62. See THE GROUP OF THIRTY, DERIVATIVES: PRACTICES AND PRINCIPLES, 43-52 (1993) (describing risks involved in derivatives transactions).

63. See *id.* at 43-44 (defining market risk in derivatives transactions). The Group of Thirty's study identified six factors that determine the market risk of a derivative: (1) "absolute price or rate risk," which is the exposure to a change in the value of the derivative (or portfolio) corresponding to a given change in the price of an underlying; (2) "convexity risk," which is the risk that arises when the relationship between a change in the value of a derivative (or portfolio) and the price of the underlying is not linear; (3) "volatility risk," which is the exposure to a change in the value of a derivative (or portfolio) resulting from a given change in the expected volatility of the price of the underlying; (4) "time decay risk," which is the exposure to a change in the value of a derivative (or portfolio) arising from the passage of time; (5) "basis or correlation risk," which is the exposure to a change in the value of a derivative (or portfolio) resulting from differences in the price performance of the sub-derivatives (or derivatives) that the derivative (or portfolio) contains, and their hedges; and (6) "discount rate risk," which is the exposure to a change in the value of a derivative (or portfolio) corresponding to a change in the rate discounting future cash flows. *Id.*

64. *Id.* at 43.

65. GAO REPORT, *supra* note 16, at 60-61.

"Credit risk" is the risk of loss due to a counterparty's default on a derivatives contract.⁶⁶ Determining the credit risk involved in a single derivatives transaction often requires a participant to evaluate both current and potential credit exposures because the credit exposure can change dramatically over the life of a derivative.⁶⁷ Determining the credit risk involved in a portfolio, on the other hand, requires a complex assessment of offsetting exposures, netting agreements with each particular counterparty, and the timing relationship among transactions in order to produce peak maximum potential exposures at different times.⁶⁸ "Operational risk," according to the Group of Thirty, is the risk of loss occurring as a result of inadequate systems and control, human error, or management failure on the part of a participant.⁶⁹ The Group of Thirty further noted that the complexity involved in many derivatives transactions requires special emphasis on maintaining adequate controls to assess and monitor both the transactions and the aggregate position of a derivatives market participant.⁷⁰

"Legal risk" is the risk of loss because a derivatives contract is legally unenforceable, including risks arising from insufficient documentation, insufficient capacity or authority of a counterparty, uncertain legality, and

66. See *id.* at 52 (defining credit risk); GROUP OF THIRTY, *supra* note 62, at 47 (same); Culp & Mackay, *supra* note 41, at 40 (same).

67. See GROUP OF THIRTY, *supra* note 62, at 47 (noting two questions that one should ask when assessing credit risk involved in individual derivatives contract). According to the Group of Thirty, one must ask two questions: (1) "If a counterparty was to default today, what would it cost to replace the transaction?" and (2) "If a counterparty defaults at some other point in the future, what is a reasonable estimate of the potential replacement cost?" *Id.* Credit risk exposures in a derivatives transaction can change rapidly and dramatically, especially in highly leveraged situations. *Id.* at 52-54.

68. See *id.* at 48-49 (explaining factors used in determining credit risk of entire portfolio which include transactions with more than one counterparty).

69. See *id.* at 50 (defining operational risk). The Group of Thirty study also listed examples of internal controls that participants engaged in derivatives trading commonly use: (1) oversight by informed and involved senior management, (2) documentation of standard policies and operating procedures including limits and exceptions, credit controls, and management reports, (3) independent risk management (analogous to credit review and asset/liability committees) that provides senior management with validation of results and utilizations of limits, (4) independent internal audits that verify adherence to the firm's policies and procedures, (5) technology and systems for handling day-to-day events, and (6) a system of independent checks and balances throughout the transaction process, from front-office initiation of a trade to final payment settlement. *Id.*

70. *Id.* at 57; see also GAO REPORT, *supra* note 16, at 67 (stating that complexity of derivatives transactions makes developing adequate risk management procedures and controls difficult).

unenforceability due to bankruptcy or insolvency.⁷¹ The GAO Report observed that some derivatives face uncertain treatment under the gambling laws of some countries.⁷² Derivatives involve more legal risk than standard financial transactions because of the innovative quality of derivatives.⁷³

Experts have suggested that derivatives also present "liquidity risk," which can involve both "market liquidity risk" and "funding risk."⁷⁴ "Market liquidity risk" is the risk that a large transaction in a particular instrument could have an adverse impact on market price.⁷⁵ "Funding risk," on the other hand, is the risk that problems in a participant's internal cash flow may cause contractual nonperformance and force the liquidation of the participant's position.⁷⁶

C. A Comparison of Exchange-Traded Derivatives and OTC Derivatives

Exchange-traded derivatives, such as futures and some options, offer the advantage of a central clearing house — the exchange itself.⁷⁷ Com-

71. See GROUP OF THIRTY, *supra* note 62, at 51 (describing various types of legal risks in derivatives transactions). See generally LAURENCE D. DOBOSH & FLORENCE D. NOLAN, CERTAIN ISSUES RELATING TO ENFORCEABILITY OF OTC DERIVATIVES (1994) (discussing legal risks in OTC derivatives transactions). For example, in January 1991, the United Kingdom House of Lords held that a London borough lacked the necessary capacity to enter into interest rate swap contracts that the borough had entered into during the 1980s and, therefore, did not have to fulfill the contracts. GROUP OF THIRTY, *supra* note 62, at 51.

72. See GAO REPORT, *supra* note 16, at 65 (noting that gambling laws of Brazil, Canada, and Singapore may forbid sale of some types of derivatives).

73. See *id.* at 64-65 (observing that uncertainty lingers over legality of some forwards contracts and netting agreements). The GAO Report noted that notwithstanding the adoption of the Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (1992), a risk that a swap contract violates the Commodity Exchange Act, 7 U.S.C. §§ 1-24 (Supp. V 1993), still exists because a court might hold that the swap is an illegal off-exchange futures contract. *Id.* For an in-depth treatment of the effects of the Futures Trading Practices Act of 1992 on the derivatives markets, see Rebecca Leon, Note, *The Regulation of Derivatives and the Effect of the Futures Trading Practices Act of 1992*, 3 J.L. & POL'Y 321 (1994).

74. See Culp & Mackay, *supra* note 41, at 41 (stating that institutions engaged in derivatives transactions can face two types of liquidity risks); see also GROUP OF THIRTY, *supra* note 62, at 46-47 (categorizing liquidity risks as market risks).

75. See Culp & Mackay, *supra* note 41, at 41 (describing market liquidity risk).

76. See *id.* (describing funding risk). Culp and Mackay stated that a failure in funding risk management was responsible for the \$1.3 billion loss reported by Metallgesellschaft AG. *Id.* Specifically, the authors cited Metallgesellschaft's inability to generate cash to finance variation margin payments on futures positions that were hedging OTC transactions as the cause for the enormous losses. *Id.*

77 See *supra* note 27 (explaining organized exchanges); see also DONALD J. MATHIESON ET AL., MANAGING FINANCIAL RISKS IN INDEBTED DEVELOPING COUNTRIES 9

monly, only "clearing" members may make trades through the exchange, and other members or investors must transact through clearing brokers.⁷⁸ Clearing members traditionally impose margin requirements on their customers that are analogous to performance bonds and hereby reduce the credit risk involved in the transactions.⁷⁹ However, because a typical margin agreement requires a participant to post both an initial margin outlay and subsequent daily maintenance outlays,⁸⁰ exchange-traded derivatives can impinge on a participant's cash flow throughout the life of the contract.⁸¹ On the other hand, OTC derivatives transactions usually provide for the settlement of profit or loss either at the expiration of the contract or at infrequent intervals.⁸²

Exchanges often subject clearing brokers to net worth requirements and other conditions designed to reduce credit risks.⁸³ In addition, as a clearinghouse, the exchange is a party in every contract and guarantees contract performance.⁸⁴ The exchange-traded derivatives markets also offer the advantage of more liquidity than the OTC derivatives market and thereby allow participants to more quickly adjust their positions as economic conditions change.⁸⁵

(1989) (comparing exchange-traded derivatives contracts with OTC derivatives transactions).

78. See MATHIESON ET AL., *supra* note 77, at 9 n.24 (observing that only "clearing" members of exchange may clear trades through clearinghouse).

79. See *id.* (stating that clearing members often impose additional margin requirements on their customers, thereby reducing credit risk involved in transactions).

80. See *id.* at 32-33 (observing that acquiring futures market position in 200 contracts of sugar would require initial outlay of \$700,000 and could require daily maintenance margin outlays of up to \$112,000).

81. See *id.* (noting that holding futures market position could require daily maintenance outlays).

82. See GROUP OF THIRTY, *supra* note 62, at 31 (observing that swaps normally provide for payments at infrequent intervals); Dean D'Onofrio, *Using Derivatives to Execute Currency Strategies*, in *MANAGING CURRENCY RISK*, *supra* note 52, at 54-55 (comparing settlement in forward contracts and futures contracts).

83. See MATHIESON ET AL., *supra* note 77, at 9 (observing that exchanges commonly impose requirements designed to reduce credit risks on clearing members).

84. See *id.* (noting that because exchanges are parties to each derivatives contract traded on exchanges, credit risk involved in exchange-traded derivatives is minimal). The resources of the exchange, rather than those of any single individual trader, guarantee each transaction. *Id.*

85. See GROUP OF THIRTY, *supra* note 62, at 32 (observing that exchange-traded derivatives market is more liquid than OTC derivatives market); MATHIESON ET AL., *supra* note 77, at 9 (same).

Unlike exchange-traded derivatives that fix transaction terms such as quantity and duration, the parties in an OTC transaction fix their own terms.⁸⁶ This "customization" allows parties to acquire more efficient hedging positions.⁸⁷ In addition, OTC derivatives entail higher credit risks than exchange-traded derivatives because settlement of an entire OTC transaction's profit or loss normally occurs either at expiration of the contract or at infrequent settlement dates.⁸⁸ Consequently, the size of payments in typical OTC derivatives contracts greatly exceeds the payments in exchange-traded contracts.⁸⁹ Compared with exchange-traded derivatives, OTC derivatives typically require higher administrative maintenance because of their complexity and lack of central clearing.⁹⁰ Therefore, using OTC derivatives usually costs more than using exchange-traded derivatives.⁹¹

III. Current and Proposed Laws and Regulations Governing Dealer Sales Practices in OTC Derivatives Transactions

The current regulatory framework governing sales practices in OTC derivatives transactions consists of an overlapping scheme of banking regulatory agencies, the SEC (through the National Association of Securities Dealers (NASD)), and the Commodity Futures Trading Commission (CFTC). Laws regulating sales practice generally fall into two categories: antifraud provisions and suitability requirements. Antifraud provisions forbid the use of untruthful or misleading information and the omission of material information in connection with the sale of certain derivatives. Suitability requirements, on the other hand, impose a duty on dealers to ensure that a proposed transaction is appropriate for a customer.

86. See GAO REPORT, *supra* note 16, at 24 (observing that parties can "customize" OTC derivatives transactions); GROUP OF THIRTY, *supra* note 62, at 30 (stating that parties customize terms of forward contracts and swap agreements); MATHIESON ET AL., *supra* note 77, at 8 (observing that parties can "customize" OTC derivatives transactions).

87. See D'Onofrio, *supra* note 82, at 54 (stating that because forward contracts can entail virtually any currency, size, and maturity, forward contracts are ideal for most cash-flow hedgers, especially banks).

88. See GROUP OF THIRTY, *supra* note 62, at 31 (observing that swaps normally provide for payments at infrequent intervals); D'Onofrio, *supra* note 82, at 54-55 (explaining that typical payment arrangements in forward contracts provide for cash settlement at close of transaction).

89. See D'Onofrio, *supra* note 82, at 55 (comparing payment arrangements in forward contracts and futures).

90. See *id.* (enumerating disadvantages of using forward contracts).

91. See *id.* (stating that lack of central clearing entailed in forward contracts requires participants to have good back office to trade at low administrative costs).

*A. A Summary of Current Laws and Regulations Affecting
OTC Derivatives Dealers*

The GAO Report identified three distinct groups of dealers in the OTC derivatives market: (1) dealers that are federally insured financial institutions or affiliated with such financial institutions, (2) dealers that are subject to federal securities or commodities regulators, and (3) other dealers.⁹² Participants in the first group include banks, thrifts, and certain bank affiliates.⁹³ Participants in the second group include registered securities dealers and futures commission merchants (FCMs).⁹⁴ Participants in the third group include the "unregulated" dealers — those not subject to regulation by either bank regulators or securities and commodity regulators.⁹⁵

As with all financial regulation in the United States, the regulatory scheme that governs participants involved in derivatives transactions is bifurcated.⁹⁶ Federal agencies subject derivatives dealers to both "institutional" regulation and "functional" regulation.⁹⁷ Institutional regulation is the regulation of participants' financial status and activities.⁹⁸ Examples of institutional regulation include restrictions on permissible activities, obligations to disclose financial information, and minimum capital requirements.⁹⁹ Functional regulation is the regulation of transactions of financial instruments and the markets in which the instruments trade.¹⁰⁰ Examples of functional regulation include transparency and price reporting obligations, antifraud and antimanipulation restrictions, position limits, and suitability requirements.¹⁰¹

92. See GAO REPORT, *supra* note 16, at 69-91 (distinguishing participants subject to bank regulators from participants not subject to bank regulators).

93. See *id.* at 69, 85 (observing that federal bank regulators oversee nationally and state chartered banks, thrifts, bank holding companies, and bank affiliates); see also *infra* notes 166-69 (describing statutory basis for jurisdiction of federal bank regulators).

94. See GAO REPORT, *supra* note 16, at 85 (identifying derivatives dealers regulated by SEC and CFTC, but not by bank regulators).

95. See *id.* at 86 (identifying "unregulated" dealers as dealers not subject to either bank regulators or to securities and commodity regulators).

96. See Culp & Mackay, *supra* note 41, at 41 (describing derivatives regulatory framework as bifurcated).

97. See *id.* (observing that regulations governing derivatives participants include both "institutional" regulation and "functional" regulation).

98. See *id.* (describing "institutional" regulation as regulation of institutions alone, as opposed to regulation of financial instruments or markets in general).

99. See *id.* at 9, 14 (listing examples of "institutional" regulation).

100. See *id.* at 9, 16 (describing "functional" regulation as regulation of financial products and markets, as opposed to regulation of users of those products and markets).

101. See *id.* at 16 (listing examples of "functional" regulation).

The focus of this Note, sales practice regulation, falls within the class of functional regulation.

*1 Regulation of Derivatives Dealers Sales Practice by the
SEC and CFTC*

a. Suitability Requirements

The SEC, through the NASD, imposes suitability requirements on OTC derivatives dealers that are registered securities dealers.¹⁰² Section 2(a) of the NASD's *Rules of Fair Practice* (RFP)¹⁰³ provides that in recommending to any customer the purchase, sale or exchange of any security, a dealer must have a reasonable belief that the recommendation is "suitable" for the customer.¹⁰⁴ In addition, RFP Section 2(b) requires a dealer to make reasonable efforts to obtain a "non-institutional" customer's financial status, tax status, investment objectives, and any other information considered to be reasonable in recommending securities transactions before the dealer executes the transactions.¹⁰⁵ Under Article V of the RFP, the NASD may impose sanctions including censure, fines, and suspension or revocation of membership for violations of the RFP by a member dealer.¹⁰⁶ The RFP suitability provisions most likely apply only to the sale of instruments that qualify as "securities" under the Securities Act of 1933 (Securities Act),¹⁰⁷ regulations thereunder, the Securities Exchange Act of 1934 (Exchange

102. See Securities Exchange Act of 1934 § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (1988) (providing that rules of SEC, together with official securities self-regulatory organizations, such as National Association of Securities Dealers, shall regulate registered OTC securities dealers).

103. NATIONAL ASSOC. OF SEC. DEALERS, RULES OF FAIR PRACTICE, *reprinted in* NASD MANUAL (CCH) ¶ 2,152 [hereinafter RFP].

104. See *id.* at art. III, § 2(a) (mandating that dealers subject to regulation of NASD must have reasonable grounds for believing that any dealer's recommendation concerning purchase, sale, or exchange of security is suitable for customer). Section 2(a) provides that the grounds upon which the dealer is to base a reasonable belief are the facts, if any, disclosed by the customer regarding the customer's other security holdings, financial situation, and needs. *Id.* The NASD evaluates dealers' sales efforts on the basis of whether they reasonably represent "fair treatment" of the customer. NASD BOARD OF GOVERNORS, SR-NASD-94-49 (1994).

105. See RFP, *supra* note 103, at art. III, § 2(b) (listing information useful in recommending securities transactions).

106. See *id.* at art. V, § 1 (listing sanctions for violation of RFP).

107. See Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1988 & Supp. V 1993) (defining "security").

Act),¹⁰⁸ and regulations thereunder (collectively, the federal securities laws).¹⁰⁹ Neither the Commodity Exchange Act (CEA) nor regulations promulgated thereunder by the CFTC address the issue of suitability

In early 1994, the SEC, the CFTC, and the United Kingdom Securities and Investments Board issued a joint statement setting forth an agenda for the oversight of the OTC derivatives market, including the review of customer protection devices.¹¹⁰ The joint statement requested relevant self-regulatory organizations (SROs) to upgrade their suitability requirements to reflect the nature of the OTC derivatives market.¹¹¹ The joint statement suggested that SROs ensure that a dealer, when recommending an OTC derivatives transaction to a customer, possess sufficient information about the customer and the customer's resources to assess the suitability of the transaction for the customer, including information indicating whether the customer has the capability to understand the risks involved in the transaction.¹¹²

b. Antifraud Provisions

The antifraud provisions of the federal securities laws¹¹³ bear upon all derivatives dealers, including federally insured banking institutions and unregistered dealers, to the extent that dealers offer and sell instruments that

108. See Securities Exchange Act of 1934 § 3(10), 15 U.S.C. § 78c(10) (1988 & Supp. V 1993) (defining "security").

109. Compare RFP, *supra* note 103, at art. III, § 2(a) (expressly pertaining only to transactions involving securities) with *id.* at art. III, § 2(b) (pertaining to "the execution of a [recommended] transaction"). The NASD has advised that the art. III, § 2 suitability requirements govern only the sale of securities. Telephone Interview with National Association of Securities Dealers, Inc. (Jan. 31, 1995). If a dealer recommended that a customer undertake a series of related transactions that involved both securities and nonsecurity derivatives instruments designed to act as hedges for such securities positions, the NASD would argue that if the securities transactions were not properly hedged, the entire transaction, both securities and nonsecurities, would be unsuitable. *Id.*

110. SECURITIES AND EXCHANGE COMMISSION, COMMODITY FUTURES TRADING COMMISSION, AND SECURITIES AND INVESTMENTS BOARD, OTC DERIVATIVES OVERSIGHT 4 (1994) [hereinafter JOINT STATEMENT].

111. *Id.*

112. *Id.*

113. See Securities Act of 1933 § 17, 15 U.S.C. § 77q (1988) (forbidding fraud in sale of securities); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1988) (forbidding contravention of SEC-promulgated antifraud rules and regulations under Exchange Act); Exchange Act Rule 10b-3, 17 C.F.R. § 240.10b-3 (1994) (prohibiting fraud in sale of securities by registered broker-dealers); *id.* § 240.10b-5 (prohibiting fraud in sale of securities generally).

meet the definition of "securities" in the federal securities laws.¹¹⁴ The federal securities laws delegate the power to enforce violations of the antifraud provisions to the SEC.¹¹⁵ The CFTC regulates dealers to the extent that dealers offer and sell futures contracts and options on futures contracts, including some types of swaps, and dealers that qualify as commodity trading advisors.¹¹⁶ The CFTC promulgated a regulation exempting certain swap agreements and participants in certain swap agreements from all the provisions, except the antifraud provisions,¹¹⁷ of the CEA.¹¹⁸ Thus, derivatives dealers that sell or recommend transactions that meet the definition of futures contracts or options on futures contracts, including certain types of swap agreements, face liability under the antifraud provisions of the CEA.

Until the BT Securities Corporation (BT Securities) settlements, which the SEC and CFTC announced on December 22, 1994,¹¹⁹ the federal regulatory agencies had not determined to what extent, if any, the federal securities laws and the CEA applied to OTC derivatives trading activities. The CFTC and the SEC announced a joint settlement with BT Securities related to BT

114. See Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (1988 & Supp. V 1993) (providing that SEC shall regulate securities market participants).

115. See Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1 (Supp. V 1993) (providing that SEC may institute administrative proceedings to enforce antifraud provisions); Securities Exchange Act of 1934 §§ 21, 21C, 15 U.S.C. §§ 78u, 78u-1 (1988) (same); *id.* at § 78o(b)(4) (granting SEC ability to limit activities of, suspend registration of, or revoke registration of registered dealers that willfully violate federal security and commodity laws).

116. See Commodity Exchange Act, 7 U.S.C. §§ 1a, 2 (1988 & Supp. V 1993) (providing that CFTC shall exclusively regulate participants in commodity futures markets and defining "commodity exchange advisor"). A commodity trading advisor is a person who, for compensation or profit, advises others about the value of commodities futures contracts, or recommends specific transactions. See *id.* at § 1a (defining "commodity trading advisor").

117. See Commodity Exchange Act §§ 4b, 4o, 7 U.S.C. §§ 6b, 6o (1988 & Supp. V 1993) (forbidding fraud in the sale of commodities futures); 17 C.F.R. § 32.9 (1994) (same). The Commodity Exchange Act (CEA) § 4b applies to all dealers, while § 4o applies only to commodity trading advisors and "commodity pool operators." Compare Commodity Exchange Act § 4b with Commodity Exchange Act § 4o. The CFTC may seek to enjoin or restrain violations of the CEA's antifraud provisions in federal court. See Commodity Exchange Act § 6(c), 7 U.S.C. § 13a-1 (1988 & Supp. V 1993) (providing that CFTC may initiate proceedings to enjoin or restrain violations of CEA in federal court). The CEA makes all violations of commodities laws felonies punishable by fines up to \$1 million. See *id.* at § 9(a)(2), 7 U.S.C. § 13(a)(2) (classifying violations of CEA as felonies and providing for punishments).

118. See 17 C.F.R. § 35.2 (1994) (exempting certain swap agreements and participants in swap agreements from all provisions of CEA except antifraud provisions).

119. BT Securities Corp., Securities Act Release No. 7,124, Exchange Act Release No. 35,136, [1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477 (Dec. 22, 1994) [hereinafter *BT Securities, SEC*]; BT Securities Corp., 1994 CFTC LEXIS 340 (Dec. 22, 1994) [hereinafter *BT Securities, CFTC*].

Securities's offer and sale of complex counterparty OTC derivatives to Gibson Greetings, Inc. (Gibson).¹²⁰ Bankers Trust Corporation (Bankers Trust), a New York banking corporation, was the counterparty to each derivative instrument that BT Securities sold to Gibson.¹²¹ Bankers Trust New York Corporation (BTNY), a publicly-traded bank holding company, owned all of the outstanding stock of both Bankers Trust and BT Securities.¹²²

In May 1991, Gibson issued \$50 million in notes with an interest rate of 9.33%.¹²³ After the issuance of the notes, interest rates declined.¹²⁴ Because Gibson could not prepay the notes for a number of years, Gibson considered engaging in interest rate swaps to effectively reduce the interest rate on the notes.¹²⁵ Gibson entered into a series of nearly thirty counterparty derivatives transactions, including amendments to existing derivative instruments, with BT Securities from November 1991 to March 1994.¹²⁶ Over time, the derivatives that BT Securities sold to Gibson became increasingly complex, risky, and intertwined.¹²⁷ Many of the derivatives had leverage factors that caused Gibson's losses to increase dramatically in relation to relatively small fluctuations in interest rates.¹²⁸ Each of the derivative instruments that BT Securities sold to Gibson was a customized OTC counterparty agreement and did not trade on any market.¹²⁹

In the SEC's settlement with BT Securities, the SEC based its jurisdictional claim on the finding that certain counterparty derivatives transactions between BT Securities and Gibson were "securities" within the meaning of the federal securities laws.¹³⁰ Specifically, the "Treasury-Linked Swap"¹³¹

120. See *BT Securities, SEC, supra* note 119; *BT Securities, CFTC, supra* note 119.

121. *BT Securities, SEC, supra* note 119, at 2; *BT Securities, CFTC, supra* note 119, at 2.

122. *BT Securities, SEC, supra* note 119, at 2; *BT Securities, CFTC, supra* note 119, at 2.

123. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

124. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

125. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

126. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

127. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

128. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

129. *BT Securities, SEC, supra* note 119, at 3; *BT Securities, CFTC, supra* note 119, at 3.

130. See *BT Securities, SEC, supra* note 119, at 11 (observing that because certain derivative instruments sold by BT Securities to Gibson fell within definition of "securities" under federal securities laws, federal securities antifraud provisions applied to transactions).

131. The terms of the "Treasury-Linked Swap" required Gibson to periodically pay to Bankers Trust (the counterparty) the London Interbank Offered Rate (LIBOR) on the \$30 million (the notional amount). *BT Securities, SEC, supra* note 119, at 7. In return, Bankers Trust would make periodic payments to Gibson equal to LIBOR plus 200 basis points on \$30 million. *Id.* At maturity, Gibson would pay Bankers Trust \$30 million; Bankers Trust would pay Gibson

and the "Knock-Out Call Option,"¹³² together with their amendments, qualified as securities.¹³³ The SEC observed that the Treasury-Linked Swap, although labeled a swap, was actually an option on a security.¹³⁴ Accordingly, the SEC ruled that the Treasury-Linked Swap fell within the federal securities laws' definition of "security."¹³⁵ Likewise, the SEC found that the Knock-Out Call Option was an option on a security and thus a "security" for the purposes of the federal securities laws.¹³⁶

Because certain transactions between BT Securities and Gibson fell within the definition of securities in the federal securities laws, the anti-fraud provisions of the federal securities laws applied to the transactions.¹³⁷ The SEC found that BT Securities had engaged in material misrepresentations and omissions in BT Securities's offer and sale of the Treasury-Linked Swap and the Knock-Out Call Option, together with their amend-

the lesser of \$30.6 million or an amount equal to:

$$\text{\$30M} \times 1 - \frac{103 \times 2\text{-yr. Treasury yld.} - 30\text{-yr. Treasury price}}{4.88\%} \times \frac{1}{100}$$

Id.

132. The "Knock-Out Call Option" was, in simplest terms, an option contract. *BT Securities, SEC, supra* note 119, at 8 n.7 BT Securities sold the Knock-Out Call Option to Gibson for a fee, or an option premium. *See id.* at 9 (referring to transactional fees charged to Gibson for entering into Knock-Out Call Option). The terms of the Knock-Out Call Option required Bankers Trust (the counterparty) to pay Gibson, on the settlement date, an amount equal to:

$$(6.876\% - \text{Yield at Maturity of 30-year U.S. Treasury security}) \times 12.5 \times \$25,000,000.$$

Id. at 8. However, if at any time during the life of the Knock-Out Call Option the yield on the 30-year U.S. Treasury security dropped below 6.48%, the option expired — or was "knocked out" — and became worthless. *Id.* In addition, the Knock-Out Call Option was not "exercisable" until the settlement date. *Id.* BT Securities marketed the Knock-Out Call Option as a hedging strategy to reduce the market risk of the Treasury-Linked Swap. *Id.* Specifically, the value of the Knock-Out Call Option would rise as the value of the Treasury-Linked Swap fell, and vice versa. *See id.* at 7, 8 (providing terms of Treasury-Linked Swap and Knock-Out Call Option, which show inverse relationship between instruments).

133. *See id.* at 6 n.6, 7, 8 & n.7 (determining that Treasury-Linked Swap and Knock-Out Call Option, together with amendments, were securities within meaning of federal securities laws).

134. *Id.*

135. *Id.* at 7

136. *Id.* at 8 & n.7, 9

137. *Id.* at 11.

ments.¹³⁸ Accordingly, the SEC determined that BT Securities violated Section 17(a) of the Securities Act,¹³⁹ Section 10(b) of the Exchange Act,¹⁴⁰ and Exchange Act Rule 10b-5¹⁴¹ when BT Securities entered into the transactions.¹⁴²

The SEC cited several specific incidents of misrepresentation.¹⁴³ For example, when Gibson asked BT Securities for valuations of Gibson's derivative positions, BT Securities provided valuations that significantly understated Gibson's losses.¹⁴⁴ In addition, the SEC found that BT Securities had omitted material valuation information when BT Securities proposed new transactions or amendments to existing transactions.¹⁴⁵ BT Securities also provided false valuations of Gibson's derivatives positions when Gibson asked BT Securities to provide valuations for use in preparing Gibson's year-end financial statements.¹⁴⁶ Gibson, relying on the false valuations, filed financial statements that materially understated Gibson's losses from derivatives activities.¹⁴⁷ Accordingly, the SEC found that BT Securities caused violations of Section 13(a) of the Exchange Act¹⁴⁸ and

138. *Id.*

139. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1988).

140. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1988).

141. 17 C.F.R. § 240.10b-5 (1994).

142. *BT Securities, SEC, supra* note 119, at 11.

143. *See id.* at 4-9 (citing specific incidents of BT Securities's fraudulent conduct).

144. *Id.* at 4-6. The SEC opinion included transcripts of telephone conversations between BT Securities employees. *Id.* at 4-5. In one conversation, a BT Securities employee advised another about how to hide misstatements made to Gibson:

I think that we should use this [downward market price movement] as an opportunity. We should just call [the Gibson contract], and maybe chip away at the differential a little more. I mean we told him \$8.1 million when the real number was 14. So now if the real number is 16, we'll tell him that it is 11. You know, just slowly chip away at that differential between what it really is and what we're telling him.

Id.

145. *See id.* at 7, 9 (observing that BT Securities omitted relevant information concerning Gibson's derivatives positions as well as transaction costs and opportunity costs associated with entering into new agreements or amendments to existing agreements). In short, BT Securities repeatedly failed to disclose adequately to Gibson how a proposed agreement or amendment would affect Gibson's overall position in terms of unrealized gains, fees, and risks. *Id.*

146. *See id.* at 5-6 (describing Gibson's requests to BT Securities for valuations of Gibson's derivatives positions to assist Gibson in preparing year-end financial reports and describing BT Securities's quotation of false values).

147. *Id.* at 10-11.

148. Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m(a) (1988).

Exchange Act Rules 13a-1¹⁴⁹ and 12b-20¹⁵⁰ when Gibson filed the misleading financial statements.¹⁵¹

The SEC observed that the derivatives that BT Securities sold to Gibson were so complex that sophisticated computer models were the only means of valuation, and, moreover, that Gibson depended solely on BT Securities to value Gibson's positions.¹⁵² Furthermore, the opinion clearly indicated that Gibson relied heavily on the advice of BT Securities concerning the suitability of the derivatives transactions.¹⁵³ However, SEC officials emphasized that the BT Securities enforcement action involved only fraud, not suitability or sales practice.¹⁵⁴

The same day that the SEC announced the BT Securities settlement, the SEC issued a release exempting dealers of certain OTC derivative instruments, to the extent that such instruments fall within the definition of "securities" under the federal securities laws, from Section 15(a) of the Exchange Act,¹⁵⁵ which requires securities dealers to register with the SEC.¹⁵⁶ Specifically, the exemption applies to any dealer that engages in individually negotiated, cash-settled OTC options on debt securities, or groups, or indexes of debt securities. The exemption, however, covers only transactions that participants document as "swaps" and that qualify for exemption under the CEA.¹⁵⁷ The SEC issued the exemption in an effort

149 17 C.F.R. § 240.13a-1 (1994).

150. 17 C.F.R. § 240.12b-20 (1994).

151. *BT Securities, SEC, supra* note 119, at 11.

152. *Id.* at 3-4.

153. *See id.* at 7-9 (observing that Gibson entered into every amendment to its Treasury-Linked Swap and Knock-Out Call Option agreements that BT Securities proposed over eight month period).

154. *See* SEC News Release 94-180, at 1 (Dec. 22, 1994) (quoting remarks made by William R. McLucas, SEC Director of Enforcement, to effect that BT Securities case was fraud, not suitability case). The BT Securities case did not attempt to address the issue of suitability or sales practice apart from enforcing antifraud provisions of the federal securities laws. Interview with Howard Kramer, SEC Associate Director, Division of Market Regulation, in Washington, D.C. (Jan. 20, 1995).

155. *See* Securities Exchange Act of 1934 § 15(a), 15 U.S.C. § 78o(a) (1988) (forbidding offer or sale of securities by unregistered dealers).

156. *See* Order Exempting Certain Brokers and Dealers From Broker-Dealer Registration, Exchange Act Release No. 35,135, Fed. Sec. L. Rep. (CCH) ¶ 85,476 (Dec. 22, 1994) (exempting dealers of certain derivative instruments, to extent that such instruments are "securities," from registration requirement under § 15(a) of Exchange Act). The exemption is temporary and will expire September 30, 1995. *Id.* at 5.

157 *Id.* at 5-6.

to avoid the possibility of a "short term dislocation" of existing OTC derivatives markets that might arise due to legal uncertainty in the wake of the BT Securities settlement.¹⁵⁸ The exemption, however, allows existing unregistered dealers of certain derivatives to avoid being subject to NASD-promulgated sales practice and suitability regulations.¹⁵⁹

The CFTC, in its settlement with BT Securities, based its jurisdiction on a determination that BT Securities qualified as a "commodity trading advisor" under the CEA¹⁶⁰ with respect to its derivatives transactions with Gibson.¹⁶¹ Specifically, the CFTC determined that BT Securities had acknowledged that it had entered into an advisory relationship with Gibson and thereby qualified as a commodity trading advisor under the CEA.¹⁶² The CFTC found that BT Securities, as a commodity trading advisor, violated Section 4o(1)(A) of the CEA¹⁶³ by defrauding Gibson.¹⁶⁴

The joint settlement with BT Securities established that the SEC and the CFTC have jurisdiction over many types of OTC swap agreements. Although the agencies have exempted the dealers in such swap agreements

158. *See id.* at 4, 5 n.3 (explaining that reason for exemption of OTC dealers is to prevent dislocation of OTC derivatives markets due to legal uncertainty). The SEC release, however, warned that the SEC did not intend the exemption to permit registered dealers conducting certain derivatives transactions to move their derivatives activities to unregistered affiliates. *Id.* at 5 n.3.

159. *See* Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 78o-3 (1988) (limiting jurisdiction of NASD to registered dealers).

160. *See* Commodity Exchange Act § 1a(5), 7 U.S.C. § 1a(5) (Supp. V 1993) (defining "commodity trading advisor").

161. *BT Securities, CFTC, supra* note 119, at 15-16; *see also infra* notes 117-18 and accompanying text (explaining CFTC's jurisdiction over swap agreements and explaining effect of exemption for swap agreements).

162. *BT Securities, CFTC, supra* note 119, at 15-16. The CFTC relied on two statements that BT Securities employees made about Gibson in determining that an advisory relationship existed between BT Securities and Gibson. *Id.* at 15. In February 1994, BT Securities's managing director for the Gibson account told his supervisor that, "from the very beginning, [Gibson] just, you know, really put themselves in our hands like 96%. And we have known that from day one." *Id.* at 15. The managing director also remarked that "these guys [Gibson] have done some pretty wild stuff. And you know, they probably do not understand it quite as well as they should. I think that they have a pretty good understanding of it, but not perfect. And that's like perfect for us." *Id.*

163. 7 U.S.C. § 6o(1)(A) (1988 & Supp. V 1993). The CFTC, however, did not find that BT Securities had violated CEA § 4b, 7 U.S.C. § 6b (1988 & Supp. V 1993). The CFTC would not have had to determine that BT Securities qualified as a commodity trading advisor if the CFTC had relied on § 4b. *See supra* note 117 (comparing CEA §§ 4b and 4o).

164. *BT Securities, CFTC, supra* note 119, at 16.

from most commodities and securities laws, the antifraud provisions of the CEA and the federal securities laws apply to these transactions. Therefore, dealers in such transactions must provide accurate and adequate information to customers or face liability under these antifraud provisions.

2. *Regulation of Derivatives Dealers by Financial Institution Regulators*

Four different federal regulators oversee federally insured banking institutions and their derivatives practices, both as dealers and as end-users.¹⁶⁵ The Office of the Comptroller of the Currency (OCC) regulates nationally chartered banks.¹⁶⁶ The Federal Reserve Board oversees state chartered banks that are members of the Federal Reserve, and bank holding companies.¹⁶⁷ The FDIC regulates state chartered banks that are not members of the Federal Reserve and, in addition, has some supervisory responsibilities for all federally insured depository institutions.¹⁶⁸ The Office of Thrift Supervision (OTS) oversees both state chartered and federally chartered thrifts.¹⁶⁹ Neither the FDIC nor the OTS have promulgated suitability requirements.

Banking Circular 277 (Circular 277),¹⁷⁰ released by the OCC in October 1993, lays out specific directives to national banks concerning the risk management of derivatives. *Circular 277* contains descriptions of the risks that are present in derivatives transactions and advice on how to identify and manage these risks effectively.¹⁷¹ When discussing credit risk management, *Circular 277* directs bank credit officials that are responsible for establishing and supervising the derivatives credit lines of customers to include an analysis of the impact of a proposed derivatives transaction on

165. Suitability requirements imposed by state bank regulators are beyond the scope of this Note.

166. See 12 U.S.C. § 24 (Seventh) (1988 & Supp. V 1993) (providing that Comptroller of Currency shall regulate securities practices of nationally chartered banks).

167. See *id.* at § 1818 (providing that Federal Reserve Board shall govern securities practices of banks that are members of Federal Reserve).

168. See *id.* at § 1818(a)(2)(A)(i) (providing that FDIC may suspend insurance of any insured bank that engages in "unsafe or unsound practices").

169. See *id.* at § 1464(c) (providing that Director of Office of Thrift Supervision shall regulate investment and securities practices of thrifts).

170. COMPTROLLER OF THE CURRENCY, *BANKING CIRCULAR 277* (Oct. 27, 1993) reprinted in Fed. Banking L. Rep. (CCH) ¶ 58,717, at 36,459 [hereinafter *CIRCULAR 277*].

171. *Id.*

the financial condition of a customer in determining the creditworthiness of the customer and to ensure the full realization of credit risk factors.¹⁷²

Circular 277 also requires bank officials to assess the applicability of proposed derivatives transactions to the customer's financial goals.¹⁷³ *Circular 277* further provides that when bank officials believe that a proposed derivatives transaction may not be "appropriate" for a customer, bank officials should inform the customer of this fact.¹⁷⁴ In such a case, the bank may follow the customer's wishes to proceed only if the bank documents both its analysis of the transaction and the information that the bank provided to the customer.¹⁷⁵

The OCC denies that *Circular 277* imposes a suitability standard on bank derivatives dealers.¹⁷⁶ Instead, the OCC contends that *Circular 277* merely serves to ensure that banks evaluate the credit risks involved in derivatives transactions using the same principles that banks use in nonderivatives transactions.¹⁷⁷ The OCC emphasizes that *Circular 277*

172. See *id.* at 36,462 (charging bank credit officers to understand impact of proposed derivatives transaction on customer's financial condition).

173. See *id.* (directing bank credit officers responsible for derivatives credit lines to understand applicability of proposed derivatives transaction to risks that customer seeks to manage).

174. See *id.* (directing bank to document both analysis that particular derivatives transaction is inappropriate and information that bank provides to customer); see also COMPTROLLER OF THE CURRENCY, QUESTIONS AND ANSWERS FOR BC-277: RISK MANAGEMENT OF FINANCIAL DERIVATIVES (OCC 94-31) (May 10, 1994), reprinted in Fed. Banking L. Rep. (CCH) ¶ 58,717, at 36,473, 36,479 [hereinafter Q&A] (instructing bank that determines that derivatives transaction is inappropriate for customer to document discussions held with customer concerning appropriateness).

175. See CIRCULAR 277, *supra* note 170, at 36,462 (permitting bank to proceed with "inappropriate" derivatives transaction if bank documents analysis of transaction and warning to customer).

176. See Q&A, *supra* note 174, at 36,478-79 (denying that CIRCULAR 277 imposes suitability standard on bank derivatives dealers); Telephone Interview with Michael L. Brosnan, National Bank Examiner, Capital Markets, Office of the Comptroller of the Currency (Feb. 7, 1995) (same).

177 See Q&A, *supra* note 174, at 36,478-79 (observing that customer's ability to perform obligations under derivatives transactions depends, in part, on appropriateness of transaction). Proper credit analysis requires that banks know about their customers' businesses. Telephone Interview with Michael L. Brosnan, National Bank Examiner, Capital Markets, Office of the Comptroller of the Currency (Feb. 7, 1995). The OCC compares a customer's ability to perform the obligations of a derivatives transaction to a borrower's ability to repay a loan. *Id.* The OCC also notes that documenting both a bank's analysis of a derivatives transaction's appropriateness and the concerns voiced to customers about inappropriateness would likely aid a bank in the event that a bank-sponsored derivatives trans-

does not prohibit banks from selling derivatives to unsophisticated customers.¹⁷⁸

A Federal Reserve Board "SR Letter" entitled *Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations* (SR Letter) contains the Federal Reserve Board's policy concerning derivatives transactions with unsophisticated customers.¹⁷⁹ Like *Circular 277*, the SR Letter requires banks to consider a derivatives customer's sophistication in the determination of credit risk.¹⁸⁰ However, in contrast with *Circular 277*, the *SR Letter* also discusses business practices.¹⁸¹ The *SR Letter* advises banks dealing with "unsophisticated" derivatives customers to ensure that such customers are aware of the particular risks of each proposed derivatives transaction.¹⁸² The *SR Letter*, however, notes that customers are ultimately responsible for the transactions that they choose to undertake.¹⁸³

On December 5, 1994, the Federal Reserve Bank of New York entered into a written agreement (Agreement) concerning sales practice and suitability of leveraged derivatives transactions (LDTs) with Bankers Trust New York Corporation and its subsidiaries (collectively BTNY), including BT Securities.¹⁸⁴ In the Agreement, BTNY agreed to ensure reasonably that each LDT customer "has the capability to understand" the elements of any

action turns out to be "unprofitable." *Id.* In such a case, documentation might help exculpate the bank in litigation and exonerate the bank in the minds of the public. *Id.*

178. See Q&A, *supra* note 174, at 36,479 (stating that CIRCULAR 277 does not prohibit bank from executing inappropriate derivatives transaction).

179. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, EXAMINING RISK MANAGEMENT AND INTERNAL CONTROLS FOR TRADING ACTIVITIES OF BANKING ORGANIZATIONS (SR 93-69) (Dec. 20, 1993), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 58,717, at 36,467 [hereinafter SR LETTER].

180. See *id.* at 36,470 (directing banks to consider customer's ability to understand and manage risks inherent in derivatives transaction in assessing credit risk).

181. Compare *id.* at 36,472 (discussing business practices with respect to derivatives transactions) with CIRCULAR 277, *supra* note 170, at 36,459 (omitting any mention of business practices concerning derivatives transactions apart from internal risk management).

182. See SR LETTER, *supra* note 179, at 36,472 (defining "sound business practices" to include ensuring that unsophisticated derivatives customers are aware of risks of each derivatives transaction). The Federal Reserve notes that customers may be unsophisticated either generally or with respect to a particular type of transaction. *Id.*

183. *Id.*

184. WRITTEN AGREEMENT BY AND AMONG BANKERS TRUST NEW YORK CORP., BANKERS TRUST CO., BT SECURITIES CORP., AND FEDERAL RESERVE BANK OF NEW YORK (Dec. 5, 1994) [hereinafter FEDERAL RESERVE AGREEMENT].

LDT that a customer undertakes.¹⁸⁵ Furthermore, BTNY agreed to provide each customer with sufficient information to allow the customer to understand the transaction.¹⁸⁶

Specifically, the Agreement requires BT to develop written policies and procedures designed to ensure reasonably that each LDT customer understands any LDT that a customer undertakes.¹⁸⁷ The policies and procedures must provide for disclosure of the basic nature, material terms, conditions, and risks of proposed LDTs.¹⁸⁸ In addition, these policies and procedures must provide for the distribution of "term sheets" and "sensitivity analyses" to customers at the closing of every LDT and upon customer request.¹⁸⁹

B. A Summary of the GAO Report's Recommendations Concerning Regulation of OTC Derivatives Dealers

The GAO Report concluded that present OTC derivatives trading practices pose a threat to the global financial system.¹⁹⁰ In particular, the GAO Report cautioned that because a few major dealers dominate the OTC derivatives market,¹⁹¹ and because OTC derivatives trading has expanded linkages among the dealers and end-users and the markets in which the dealers and end-users trade,¹⁹² a failure of one of the major dealers could cause liquidity problems in the markets, which could, in turn, set off a global financial crisis.¹⁹³ In addition, the GAO Report observed that the FDIC insures many of the major OTC derivatives dealers and that a chain

185. *Id.* In addition, BTNY agreed to develop and submit to the Federal Reserve Bank of New York written policies and procedures designed to ensure reasonably that each LDT customer has the capability to understand all the elements of any LDT a customer undertakes. *Id.*

186. *Id.* In addition, BTNY agreed to develop and submit to the Federal Reserve Bank of New York written policies and procedures designed to ensure reasonably that BTNY discloses to each LDT customer sufficient information to allow the customer to understand all the elements of any LDT that BTNY enters into with the customer. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. See GAO REPORT, *supra* note 16, at 9-14 (summarizing findings that regulatory gaps in OTC derivatives trading heighten risk of systemic collapse).

191. *Id.* at 36-37

192. *Id.* at 37-39.

193. *Id.* at 107, 123.

reaction of failures could require a federal bailout far exceeding the savings and loan disaster.¹⁹⁴

Although the GAO Report concentrated on bank safety and soundness concerns, deficiencies in risk management, and systemic risk, the GAO Report also observed that no government agency regulates many OTC derivatives dealers and expressed alarm over this regulatory "gap."¹⁹⁵ The GAO Report also noted that each of the five major securities firms that acted as derivatives dealers in 1993 conducted their derivatives activities through one or more unregistered affiliates.¹⁹⁶ According to SEC officials, the treatment of OTC derivatives under the SEC's capital requirement provisions has influenced registered dealers to conduct derivatives activities through unregistered affiliates.¹⁹⁷

The GAO Report urged Congress to bring the unregulated OTC derivatives dealers under the oversight of federal regulators to ensure that derivatives regulation is comprehensive.¹⁹⁸ The GAO Report suggested two solutions: (1) expand the jurisdiction of the SEC to include all OTC deriva-

194. *Id.* at 124-25.

195. *See id.* at 86-87 (observing that neither SEC nor CFTC directly regulates activities of OTC derivatives dealers that are not either registered dealers or futures commission merchants).

196. *See id.* at 87 (observing that each registered securities dealer in survey conducted derivatives activities in one or more unregistered and, thus, unregulated affiliates).

197. *See id.* at 88-89 (explaining reasons securities dealers use unregistered affiliates to offer and sell derivatives). The GAO Report observed that the SEC uses the net capital rule to oversee the financial soundness of registered dealers. *Id.* at 88. The net capital rule provides that no dealer shall permit the dealer's aggregate indebtedness to exceed 15 times the dealer's net capital. 17 C.F.R. § 240.15c3-1(a)(1)(ii) (1994). The rule allows a dealer to include the value of all the assets, including securities, held by the dealer in calculating the dealer's net capital. *Id.* § 240.15c3-1(c)(2). Under the rule, however, a dealer must discount the value of the assets, including securities, held by the dealer by various amounts (called "haircuts") depending on the liquidity and riskiness of the assets. GAO REPORT, *supra* note 16, at 88. In applying the net capital rule to swaps, registered dealers are to add to their net worth the value of any swaps with unrealized positive market value and subtract from their net worth the value of any contracts with a negative market value. *Id.* In addition, however, dealers must deduct from their net worth calculation, the value of any swap payments due to them as unsecured receivables. *Id.* at 89. Dealers must further reduce any swap with a positive market value by up to 6% of the notional amount of the contract, depending on the term of the swap and whether the dealer has offset or hedged the swap. *Id.* The net capital rule also requires dealers to subtract various percentages of the market value of other derivatives when calculating net capital. *Id.* Therefore, derivatives can tie up large portions of a registered dealer's capital. *Id.*

198. GAO Report, *supra* note 16, at 127

tives dealers¹⁹⁹ and (2) divide responsibility for regulating OTC derivatives dealers among the various securities, commodities, and financial regulators on the basis of each agency's expertise and mission.²⁰⁰

*C. Proposed Legislation Affecting Suitability Requirements for
OTC Derivatives Dealers*

Of all the legislation governing derivatives that legislators introduced in 1994 and 1995, only one bill, House Bill 4745 (HB 4745), endeavored to fill the perceived gap in the regulation of OTC derivatives dealers.²⁰¹ In its most basic terms, HB 4745 would amend the Exchange Act to include derivatives within the definition of "securities."²⁰² HB 4745 would encompass virtually all OTC derivatives dealers because the legislation broadly defines "derivative."²⁰³ The bill would require every OTC derivatives dealer to either (1) register with the SEC as a securities dealer if the participant is not affiliated with a registered securities dealer or (2) notify the SEC in writing that the participant is a derivatives dealer if the participant is "materially associated" with a registered securities dealer.²⁰⁴

HB 4745 would subject all dealers that must register with, or notify, the SEC of derivatives activity to all the provisions of the federal securities laws, including the antifraud provisions.²⁰⁵ The bill also would expressly

199. *Id.*

200. *Id.*

201. Compare H.R. 4745, 103d Cong., 2d Sess. § 201 (1994) (providing that SEC shall have jurisdiction over OTC derivatives dealers) with H.R. 31, 104th Cong., 1st Sess. (1995) (pertaining only to financial institutions) and H.R. 20, 104th Cong., 1st Sess. (1995) (same) and S. 2291, 103d Cong., 2d Sess. (1994) (same) and H.R. 4503, 103d Cong., 2d Sess. (1994) (same) and S. 2123, 103d Cong., 2d Sess. (1994) (same) and H.R. 4170, 103d Cong., 2d Sess. (1994) (same) and H.R. 3748, 103d Cong., 2d Sess. (1994) (same).

202. See H.R. 4745, 103d Cong., 2d Sess. § 201 (1994) (amending definition of "securities" in Securities Exchange Act § 3(10) to include "derivatives").

203. See *id.* § 2 (defining derivative to include any instrument that derives its value from value or performance of any security, currency exchange rate, or interest rate).

204. See *id.* § 101 (prohibiting sale of derivatives by unregistered dealers unless dealer is "materially associated" with another registered dealer and has notified SEC of derivatives activity). HB 4745 would require not only derivatives dealers to register with the SEC, but the bill also would require any entity that buys, sells, or enters into OTC derivative instruments for that entity's own account to register. *Id.* HB 4745, however, would allow the SEC to unconditionally exempt any derivatives market participant or class of participants from the registration requirement. *Id.*

205. See *id.* (subjecting dealers willfully violating any provision of federal securities laws to suspension or revocation hearings under § 15(b)(4) of Exchange Act).

delegate to the SEC the authority to promulgate additional rules and regulations designed to prevent fraudulent, deceptive, or manipulative acts in derivatives transactions.²⁰⁶ In addition, HB 4745 would require all derivatives dealers that are required to register with the SEC also to register with the NASD.²⁰⁷ This registration requirement would subject such dealers to the NASD's rules, including sales practice requirements.²⁰⁸

IV An Analysis of OTC Derivatives Dealer Suitability Requirements

All sides agree that derivatives are useful and important to the economy.²⁰⁹ Commentators and regulators have repeatedly warned against enacting inappropriate initiatives designed to regulate derivatives.²¹⁰ The GAO Report itself acknowledged that unilateral regulatory action by the United States could hamper American firms' competitiveness and encourage these firms to move their derivatives activities off-shore.²¹¹

The GAO Report expressed concern over the gap in regulation of unregistered OTC derivatives dealers.²¹² The SEC, however, preserved the gap in December 1994 by exempting unregistered dealers that engage in certain derivatives transactions from SEC registration to the extent that the

206. *Id.*

207. *See id.* (requiring every derivatives dealer to register with securities association). Currently, the NASD is the only such securities association. The bill, however, would allow the SEC to unconditionally exempt any derivatives dealer or class of derivatives dealers from the securities association registration requirement. *Id.*

208. *See supra* notes 102-09 and accompanying text (explaining NASD's rules regarding sales practice).

209. *See* GAO REPORT, *supra* note 16, at 123 (describing derivatives as important to global financial marketplace); GROUP OF THIRTY, *supra* note 62, at 63 (enumerating benefits of financial innovation); Culp & Mackay, *supra* note 41, at 39-40 (describing benefits of OTC derivatives to end-users and dealers).

210. *See Derivatives Market: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 104th Cong., 1st Sess. (1995) (statement of Alan Greenspan, Chairman, Federal Reserve Board) (warning that singling out derivatives for special regulatory treatment would be "serious mistake"); Culp & Mackay, *supra* note 41, at 48 (proposing new type of risk inherent in derivatives — "regulatory risk"); Thomas C. Theobald, *Regulatory Chokehold: Derivatives Aren't the Danger*, WALL ST. J., May 23, 1994, at A14 (arguing that market forces will provide more efficient oversight of derivatives than new government regulation).

211. GAO REPORT, *supra* note 16, at 107 (warning that excessive regulation will drive derivatives activities overseas); *see also* Culp & Mackay, *supra* note 41, at 50 (same).

212. *See supra* notes 195-97 and accompanying text (describing GAO Report's concern over unregulated OTC derivatives dealers).

dealers offer and sell securities.²¹³ The SEC recognized that forcing previously unregulated derivatives dealers to register with the SEC and thus subjecting these dealers to stringent capital, reporting, and sales practice requirements, might result in a "dislocation" of existing OTC derivatives markets.²¹⁴ The Group of Thirty's survey also played down the need to close the gap in regulation.²¹⁵

Regulators impose suitability requirements on dealers for two principal reasons:²¹⁶ (1) to reduce dealers' credit risk exposure²¹⁷ and (2) to protect unsophisticated customers.²¹⁸ First, suitability requirements reduce dealers' credit risk exposure by forcing dealers to include an evaluation of the suitability of a proposed derivatives transaction in assessing the credit-worthiness of prospective derivatives counterparties.²¹⁹ Second, suitability requirements protect unsophisticated customers by forcing dealers to assess the appropriateness of derivatives transactions that dealers undertake with customers.²²⁰ The credit risk exposure of derivatives dealers concerns bank regulators more than securities and commodities regulators.²²¹ Both bank

213. See *supra* notes 155-59 and accompanying text (describing SEC's order exempting certain swaps dealers from SEC's registration requirement).

214. See Order Exempting Certain Brokers and Dealers From Broker-Dealer Registration, *supra* note 156, at 5 n.3 (explaining that SEC issued exemption to avoid dislocation of current OTC derivatives markets); cf. *Municipal Bond and Government Securities Markets: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 104th Cong., 1st Sess. (1995) (prepared testimony of Arthur Levitt, Chairman, Securities and Exchange Commission) (stating that SEC staff will analyze how rules regarding capital requirements and sales practice apply to OTC derivatives markets in preparation for expiration of exemption).

215. See GROUP OF THIRTY, *supra* note 62, at 63 (observing that unregulated derivatives dealers have promoted competition and innovation without any evidence of increased systemic risk).

216. Regulators also impose suitability requirements to protect the reputations of the entities they regulate. See *supra* note 177 (describing effects of suitability requirements on reputation of bank). Suitability requirements protect dealers' reputations by ensuring that dealers act fairly when dealing with unsophisticated counterparties. See *id.*

217. See *supra* note 177 and accompanying text (explaining that appropriateness requirement in *Circular 277* reduces credit risk).

218. See *supra* notes 103-05 (explaining how NASD's RFP seek to protect unsophisticated customers).

219. See *supra* note 177 and accompanying text (explaining that *Circular 277*'s appropriateness requirement is designed to reduce unperceived credit risks of banks).

220. See *supra* notes 103-05 and accompanying text (describing NASD's suitability standard).

221. Compare *Circular 277*, *supra* note 170 and *SR LETTER*, *supra* note 179 (both

regulators and securities regulators, however, seek to protect unsophisticated customers.²²² Because experts generally agree that regulation of federally insured banks' credit risk exposure is necessary, if not beneficial, the remainder of this Note will evaluate suitability requirements designed to protect unsophisticated customers.

Suitability provisions alter the traditional arms-length relationship between buyers and sellers by requiring derivatives dealers to protect their customers' interests.²²³ Markets function most efficiently when parties to a financial transaction are free to enter into the transaction unhampered by a perceived need to serve the interests of their counterparties.²²⁴ Suitability requirements would increase transaction costs in the derivatives market.

Relationships between buyers and sellers in the derivatives market, however, can differ from such relationships in other markets. Derivatives dealers often advise clients and recommend specific transactions.²²⁵ In an advisory relationship, a dealer's profit motive conflicts with the

stating that appropriateness requirements serve to reduce bank credit risk exposures) *with RFP, supra* note 103, at art. III, § 2 (imposing suitability requirement, but not to reduce dealer credit risk exposure).

222. See *supra* notes 184-89 and accompanying text (explaining that Federal Reserve's Written Agreement with BTNY sought to protect prospective derivatives customers); *supra* notes 103-05 and accompanying text (explaining how NASD's RFP seeks to protect customers).

223. See DERIVATIVES POLICY GROUP, FRAMEWORK FOR VOLUNTARY OVERSIGHT 37 (1995) (stating that OTC derivatives transactions are predominantly arm's-length in nature); Memorandum from the Drafting Committee of PRINCIPLES AND PRACTICES FOR WHOLESALE FINANCIAL MARKET TRANSACTIONS 7-8 (Aug. 17, 1995) (on file with the *Washington and Lee Law Review*) (same). The Derivatives Policy Group, which consists of six major OTC derivatives dealers, promulgated FRAMEWORK FOR VOLUNTARY OVERSIGHT in cooperation with the SEC and CFTC. DERIVATIVES POLICY GROUP, *supra*, at 1. The FRAMEWORK FOR VOLUNTARY OVERSIGHT sets out, among other things, a code of conduct for dealing with derivatives customers that the members of the Derivatives Policy Group have voluntarily agreed to follow. *Id.* at 1, 37. Likewise, PRINCIPLES AND PRACTICES FOR WHOLESALE FINANCIAL MARKET TRANSACTIONS, which was drafted by representatives of the Federal Reserve Bank of New York and several financial industry groups, provides a voluntary set of standards and principles governing the relationship between derivatives market participants. PRINCIPLES AND PRACTICES FOR WHOLESALE FINANCIAL MARKET TRANSACTIONS (1995).

224. See *Derivatives Market: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 104th Cong., 1st Sess. (1995) (statement of Alan Greenspan, Chairman, Federal Reserve Board) (analyzing derivatives dealer-customer relationship).

225. See *BT Securities, SEC, supra* note 119 (involving derivatives transactions recommended by dealer); see also *supra* note 14 and accompanying text (describing alleged advisory nature of derivatives dealer-customer relationships).

dealer's responsibility to advise the customer fairly²²⁶ Nonetheless, customers should recognize that derivatives dealers that act in an advisory capacity have conflicting interests and should treat dealer recommendations accordingly Customers can either rely on their own judgment or seek advice from third party consultants.²²⁷ The Group of Thirty's study concluded that market participants can evaluate for themselves the risks and benefits of trading with unregulated derivatives dealers.²²⁸ Indeed, the publicity surrounding the huge losses suffered by some derivatives traders has raised the consciousness of the average unsophisticated derivatives customer.²²⁹

Suitability requirements for derivatives dealers enacted to protect customers seem inconsistent with the ideals underpinning the federal securities laws. Whereas securities disclosure provisions seek to protect the average household investor, derivatives customers are typically major corporations or professional money managers.²³⁰ Furthermore, whereas securities disclosure provisions endeavor to promote confidence and participation in the securities market, suitability requirements may effectively deny unsophisticated customers access to the derivatives market because the costs of compliance with suitability requirements may dissuade dealers from dealing with such customers.²³¹

Moreover, the antifraud provisions of the federal securities laws and the CEA arguably obviate the need for suitability requirements. Thus far, one aggrieved derivatives customer that sued a dealer claiming fraud has settled its suit successfully²³² In addition, the antifraud laws provide

226. See *BT Securities, SEC, supra* note 119 (involving advisory relationship in which dealer misled client as to value of client's derivatives contracts); *Derivatives Market: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 104th Cong., 1st Sess. (1995) (statement of Alan Greenspan, Chairman, Federal Reserve Board) (discussing advisory nature of some derivatives dealers' relationships with customers).

227. See Saul Hansell, *Derivatives Draw More Scrutiny*, N.Y. TIMES, Jan. 3, 1995, at C39 (describing derivatives consulting business as fastest growing segment of derivatives market).

228. GROUP OF THIRTY, *supra* note 62, at 63.

229. See *supra* notes 8-15 and accompanying text (describing recent well-publicized events involving derivatives).

230. See Culp & Mackay, *supra* note 41, at 46 (stating that overwhelming majority of OTC derivatives customers are sophisticated institutional investors).

231. See *id.* (arguing that suitability requirements will prompt dealers to avoid less sophisticated customers).

232. See *supra* note 15 and accompanying text (describing Gibson's settlement with BT Securities).

broader coverage than the current suitability regulations because antifraud laws apply to derivatives transactions with unregistered dealers.²³³

In the alternative, suitability provisions may be unnecessary because market factors will force dealers to ensure that recommended derivatives transactions are appropriate for unsophisticated customers. Because suitability is a creditworthiness concern,²³⁴ a dealer that enters into a derivatives transaction as a counterparty has an incentive to ensure that the transaction is appropriate for the customer.²³⁵ Likewise, the market motivates derivatives dealers to ensure customer satisfaction and to protect their reputations for fairness.

V Conclusion

While laws requiring a dealer to consider whether a proposed derivatives transaction is appropriate for a customer enhance credit risk management by dealers and reduce systemic risk, suitability requirements aimed at protecting unsophisticated derivatives customers are both unnecessary and harmful. The current regulatory regime requires most derivatives dealers to observe the antifraud provisions of the federal securities acts and the CEA and thus adequately protects customers.

233. See Order Exempting Certain Brokers and Dealers From Broker-Dealer Registration, *supra* note 156, at 4 (subjecting unregistered derivatives dealers to antifraud provisions of federal securities laws to extent that dealers offer and sell securities).

234. See *supra* note 177 and accompanying text (explaining that suitability is relevant in creditworthiness analysis).

235. See Culp & Mackay, *supra* note 41, at 46 (observing that because most derivatives transactions create long term credit exposures, dealers have incentive to ensure counterparty suitability).