INFORMATIONAL ASYMMETRY AND OTC TRANSACTIONS: UNDERSTANDING THE NEED TO REGULATE DERIVATIVES

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I. INTRODUCTION

Derivatives. Commonly defined as "investment contracts whose values are linked to price movements in markets where stocks, commodities or other assets are actively traded."1 They are spin-offs, or by-products, of the underlying securities on which their values are based.2 That sounds simple enough. One does not have to be a rocket scientist to understand them; or does he? Many of the people responsible for creating derivatives on Wall Street have advanced degrees in subjects such as engineering and physics, and the theories and techniques of the physical sciences are increasingly being applied to finance.3 "The

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2See, e.g., Derivatives Bite Bankers, SAN FRANCISCO CHRON., Dec. 23, 1994, at C8, C8 (defining derivatives as "controversial, often speculative investments that are based on underlying securities, such as currencies, commodities, or interest rate-based contracts").

3Jeffrey Hoffman, Wall Street Bets Its Future on Computer Whizzes: Markets: But Some Find There is Economic Peril When Intelligence is Substituted for Wisdom. O.C.'s Bankruptcy is Often Cited as a Case in Point, L.A. TIMES, June 2, 1995, at D7. See also John Micklethwait, Barings' Failure: A Case of "Upstairs, Downstairs," L.A. TIMES, Mar. 5, 1995, at M1 (indicating that "[d]erivatives are priced according to complicated mathematical formulas that only computers or rocket scientists can work out"); Gregory J. Millman, Derivatives as Dump Trucks; They Are Risky, But They Haul Away the Refuse of Bad Government Policy, WASH. POST, Dec. 18, 1994, at C2 (explaining that "[f]inancial engineers, many of them holding PhDs in mathematics, physics or other sciences, designed new derivatives contracts to function like a form of financial insurance").

In Let's Take This Slowly; What's an Atom, Again?, WALL ST. J., Jan. 18, 1995, at S2, Eleena de Lisser reports that three finance professors at the University of South Carolina, using physics to value preferred stocks,

used Merton's equation, a virtually indecipherable finance equation used to value derivative securities, which in turn is based on Schrodinger's equation, an equally puzzling physics formula that gauges heat and temperature changes.

Adapting the formula for their purpose, they put it into a mainframe computer, plugging in information such as interest rates, call provisions and conversion features, and waited for the results.

De Lisser, supra. However, it must be remembered that "financial markets and economic policy are still dominated by humans, whose behavior doesn't always conform to the models."
securities industry, once a genteel, paper-based business, is now an
electronic realm where a mastery of computers and strong quantitative
skills are required.4

With the possible exception of these "quaint jocks," does anyone
really know what derivatives are? A consideration of recent events
suggests a negative answer. Of course, no one denies understanding these
financial instruments until huge losses are realized and a scapegoat is
needed to take the blame. Almost invariably, the situation turns into one
in which shareholders blame management, management blames the
financial institution that created and sold the derivatives, and the financial
institution swears it acted appropriately. Somewhere along the line,
someone may lose his job or his million dollar bonus.5

Given recent negative publicity, one would think that companies
would be loathe to use derivatives. Yet, polls indicate that many major
corporations continue to use the risky financial instruments.6 It may be
that potential investors are irrational, or that they "are systematically
given misleading and biased information and have no ability to evaluate
its inaccuracies."7 But perhaps the reason for continued investment in
derivatives trading is that derivatives are not inherently bad.8 When

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Hoffman, supra, at D7.

4Hoffman, supra note 3, at D7.

5See Matt Murray & Paulette Thomas, Wall Street's Derivatives Debacle: When
Fingers Point and Heads Roll, WALLST. J. EUR., Dec. 27, 1994, at 9, 9, available in LEXIS,
News Library, Curnws File. This article notes that in 1994, "employees who made the buying
decisions were fired or demoted at Procter & Gamble Co., Mellon Bank Corp., Gibson
Id. Some of the fired employees did not violate company policy, but were fired for "guessing
wrong on interest rates and currency swings, or being misled about risks by cagey salesmen."
Id. Interestingly, "no top executives lost their jobs at any of those companies." Id. The article
does note, however, that two top executives at Mellon's Boston Company unit were fired. Id.
The fired employees did not violate company policies and were fired "for guessing wrong on
interest rates and currency swings, or being misled about risks by cagey salesmen." Id. See
also Paulette Thomas, Procter & Gamble Sues Bankers Trust Because of Huge Losses on
Derivatives, WALLST. J., Oct. 28, 1994, at A6, A6 (indicating that "[a]fter posting a $157
million pretax charge, [P & G] fired Raymond Mains, its treasurer, and Mr. Arzt [chairman
and CEO of P&G] cut his own bonus by $100,000, reducing his pay to $2.3 million").

6Eighty-three percent of CEOs from 200 of America's biggest corporations stated that
they are satisfied with the way their derivatives have performed. Terence P. Paré, Learning
to Live with Derivatives, FORTUNE, July 25, 1994, at 106, 108 (citing CEO Poll: Derivatives
Are Here to Stay). Ninety-two percent do not plan to make any changes in the way they use
derivatives. Id.

7Edwin J. Elton et al., Commodity Funds: Does the Prospectus Really Tell All?, in
THE INVESTMENTS READER 250, 253 (Robert W. Kolb ed., 1991) (providing reasons why
investors continue to purchase commodity funds).

8See, e.g., Bruce A. Baird et al., Current Legal Theories in Litigation Involving
properly used, these financial instruments can be powerful tools that lend greater stability to business operations by allowing companies to reduce risk. Companies often use derivatives "to hedge against big losses in securities and currencies." For instance, transnational companies use derivatives to minimize their risk from shifts in currency values and movement in foreign interest-rates. In addition, companies use derivatives to lock in at fixed currency or interest rate values for a period of months or years, enabling them to plan spending and operating budgets with some certainty.

Derivatives contracts may be sold either at an exchange as standardized contracts, or privately through the over-the-counter (OTC) market as customized contracts. Trade in these new products "represent[s] a growing part of derivatives activity." The customized OTC transactions are privately negotiated by two parties: the seller (or dealer) and the buyer (or end-user). The dealer's role in the derivatives market has developed as a result of the changing economic climate. As corporations have become more international and rely more heavily on foreign markets, Wall Street financial institutions have developed new products to help corporate clients manage varied financial risks. As computers have become more powerful, Wall Street has been able to

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*Derivative Contracts*, C123 ALI-ABA 291, 299 n.9 (1995) (quoting Interview by Inside Opinion (CNBC television broadcast, Jan. 19, 1995)) (quoting SEC Commissioner Richard Roberts, as stating that "[d]erivatives are not inherently bad or good, but they are volatile.").

*Saul Hansell, Derivatives Take the Rap for Many Losses; Bankers and Economists Wary of Backlash, Say Financial Tool Useful When Understood, SAN DIEGO UNION TRIB., Oct. 2, 1994, at 14. See also Robert Reno, Derivatives Are Smearing Image of Mutual Funds, NEWSDAY, Oct. 6, 1994, at A59 (stating that, when used properly, "derivatives are perfectly safe and highly useful instruments which can minimize rather than elevate risk.").


*Hansell, *supra* note 9, at 14.

*Id.*

*COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 4 (May 1994) [hereinafter GAO REPORT].

*Id.* at 30.


*Baird et al., supra* note 8, at 300 (explaining that "the derivatives dealer often assumes three roles — the role of the financial advisor who identifies the need for a product, an issuer who designs the product, and a broker who negotiates the product" and because of the complexities of derivatives, dealers often custom design a derivative to fit a customer's specific needs).

*Hoffman, supra* note 3, at D7.
provide investment products and services offering greater risk management, more choices, and potentially higher returns.\footnote{Id.}

Similarly, participation by end-users in the derivatives market has developed as a function of the global economy. Due to the growth of multinational corporations and the increasing reliance on foreign markets, the traditional duties of a corporation’s treasurer have changed.\footnote{Fred R. Bleakley, *Multinational Firms Bet Against the Dollar: Corporate Treasurers Took a Few Chances to Profit From Falling Currency*, ASIAN WALL ST. J., Apr. 18, 1995, at 24, available in LEXIS, News Library, Curnws File.} Today, the treasurer’s most important job has become risk management.\footnote{Id.} Responding to the growing importance of foreign exchange and interest markets, corporations are better able to hedge their risks through the use of sophisticated derivatives products.\footnote{Id. (calling risk management the treasurer’s "most sensitive, and controversial, job these days").}

For example, the historical decline of the dollar against most foreign currencies has helped American-based multinational corporations with their bottom lines.\footnote{See id.} Treasurers who helped make huge profits for their companies were not wild-eyed speculators or unsophisticated bookkeepers who guessed right. Instead, operating within the confines of board approved policies that regulators would consider prudent, many treasurers merely leaned in the right direction of a trend. Others also stood to gain who did nothing. Their companies routinely leave all or a portion of their currency exposure unhedged.\footnote{Id. Treasurers have "made money for their companies off the plunge in the dollar."}

However, "[n]ow, as they move to lock in their profits, it’s becoming clear they also took a few chances to add to the gains."\footnote{Bleakley, supra note 19, at 24.} In developing derivatives contracts specifically for a particular firm, the bank acquires information about the company’s assets, liabilities, and financial objectives and advises the corporation as to what its objectives should be and how to obtain them.\footnote{Id.} Because of the advisory role assumed by the investment bank selling the instruments, the client’s financial officers assume that the bank created the derivative.

\footnote{Baird et al., supra note 8, at 300.}
contract with the company's preferred level of risk in mind. The financial officers may, therefore, enter into derivatives contracts without a clear understanding of the risks involved. However, banks and other financial intermediaries may create and sell derivatives without accurately explaining the risks involved. When the parties to the contract do not fully understand the terms of a particular transaction, obvious problems arise. Indeed, because derivatives present risks and benefits, they have been compared to electricity — "dangerous if mishandled but bearing the potential to do tremendous good."

This article will discuss the problems associated with informational asymmetries in OTC derivatives trading. Part II briefly compares OTC contracts with exchange-traded derivatives and concludes that the relationship between the two types of financial instruments presents a need to regulate both. Part III discusses the relationships involved in OTC transactions, and the ways in which the interests of each of the parties come into conflict. Part IV examines the viability of legislation, regulation, and development of a firm's own internal controls, and concludes that there is a need for regulation. Finally, Part V offers proposed regulations.

II. THE CURRENT STATE OF DERIVATIVES

There are a number of differences between exchange-traded derivatives and OTC derivatives. For instance, the price of exchange-traded derivatives is determined on the floor of the organized exchange where buyers and sellers or their representatives meet to determine derivatives prices. In contrast, there is no market for a customized OTC contract, and without a market, there is no fixed way to determine fair

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26See id.
27See id. (pointing out that most end-users do not have the necessary resources to understand and monitor the risks).
28It is possible that the banks or their representatives do not fully understand (or appreciate) the risks involved with particular derivatives. The increased reliance of traders on computers to handle customer accounts and to perform their other responsibilities has brought new dangers to Wall Street. Hoffman, supra note 3, at D3. For some traders, the new technology on Wall Street has become "a high stakes version of the video games teen-agers play in arcades." Id. (quoting David Bostian, chief economist for Herzog, Heine, Geduld, a New York-based investment firm).
30See GAO REPORT, supra note 13, at 4.
value. The investment bank creating the derivatives may be the only institution with enough information to compute the value of the financial instruments and, therefore, can name its own price. Because investment banks are able to demand any price, certain highly complex transactions involving combinations of derivatives can generate large brokers' fees.

Moreover, exchange-traded instruments are currently subject to Federal regulation. The primary purposes of the Securities Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) are "to protect investors or customers in the public securities and futures markets and to maintain fair and orderly markets." Thus, a major reason for regulating exchange-traded products is to protect the market. In contrast, neither the SEC nor the CFTC regulate OTC derivatives or dealers of such instruments unless the trading is conducted in a regulated institution. This is because OTC derivatives fall outside the definition of "securities." Indeed, "certain derivative securities traded otherwise than on a national securities exchange" are specifically exempted from certain provisions of the Securities Act of 1934. Perhaps the different treatment is justified because it is feared that losses related to exchange-traded instruments will be felt throughout the market, while losses involved in OTC transactions are felt mainly by the parties to the contract. This, however, may prove to be a misconception:

32 Id.
33 Because the majority of derivatives are unregulated, many of them aren't priced on a formal exchange. The more exotic ones, such as those that buffalored Procter & Gamble and Gibson Greetings last year, were so bizarre that the investment company behind them, Bankers Trust, priced them any way it wished.
34 GAO REPORT, supra note 13, at 29-30. This is especially important to the investment banks now, at a time in which "Wall Street firms face declining income in their traditional activities of underwriting and trading stocks and bonds." Hoffman, supra note 3, at D7.
35 Id. at 86.
36 Id. at 85.
38 17 C.F.R. § 240.3a12-7 (1996).
39 GAO REPORT, supra note 13, at 85.

As in the case of a major bank failure, a crisis involving derivatives that affects one of these firms would likely affect the financial system and require
Because the same relatively few major OTC derivatives dealers account[ ] for a large portion of trading in a number of markets, regulators and market participants fear[ ] that the abrupt failure or withdrawal from trading of one of these dealers could undermine stability in several markets simultaneously. This could lead to a chain of market withdrawals, or possibly firm failures, and a systemic crisis.\textsuperscript{40}

On the other hand, exchange-traded losses may be confined to certain institutions in the economy. Consider, for example, the 1995 Barings P.L.C. disaster. In this well-publicized fiasco, Nicholas William Leeson bankrupted a centuries-old bank by his abuse of exchange-traded derivatives.\textsuperscript{41} The derivatives Leeson used required an initial cash outlay of only six percent, giving him "enormous leverage that could quickly magnify" any gains or losses.\textsuperscript{42} At first, Leeson was using the derivatives to hedge risk.\textsuperscript{43} He bought investments in one market and sold them in another, hoping to profit by a favorable price differential between the two markets.\textsuperscript{44} Then, Leeson began losing,\textsuperscript{45} and as his losses accumulated, he increased the risk level of the transactions in an attempt to break even.\textsuperscript{46} Instead, the continued trading resulted in huge losses that exceeded the bank's cash reserves.\textsuperscript{47} Prior to the Barings incident it had been feared that in our global economy one major loss could collapse.

\begin{itemize}
  \item federal intervention to resolve. Although the federal government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, the federal government is likely to intervene to keep the financial system functioning in cases of severe financial stress.
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\textit{Id.\textsuperscript{40}}

\textit{Id.\textsuperscript{41}} at 39.

\textit{Heberlein, supra note 32, at F1.\textsuperscript{42}}

\textit{Id.\textsuperscript{43}}

\textit{Id.\textsuperscript{44}}

\textit{Id.\textsuperscript{45}}

\textit{Barbara Sullivan & Ray Moseley, Old Bank, Modern Scandal; Manhunt Under Way for "Rogue Trader," CHT. TRIB., Feb. 28, 1995, at N1.\textsuperscript{46}}

\textit{Id.} "Instead of taking his losses as the Japanese stock market began to go down, Leeson apparently began to double his bets, in hopes of getting even when the market went back up." \textit{Id.} This behavior is consistent with behavior observed in connection with racetrack betting. \textit{See Richard H. Thaler, The Winner's Curse: Paradoxes and Anomalies of Economic Life 135 (1992) (indicating that at the racetrack, favorite-longshot bias becomes more pronounced late in the day, when the average bettors are losing; because they would like to go home as winners, they bet on longshots — hoping to break even).} \textit{Id.\textsuperscript{47}} Sullivan & Moseley, supra note 45, at 1.
other financial Institutions.48 Thus, some U.S. investors were actually comforted by the loss sustained by Barings.49 As one derivatives market analyst has noted, "In many ways it's almost a source of comfort that there can be a failure of a well-known institution without causing serious havoc."50

One question raised by the Barings debacle is: how such a "prestigious bank could have let a young trader jeopardize its . . . reputation with such huge and risky bets?"51 Bank of England Governor Eddie George has indicated that the crisis was a result of Barings' management's failure to monitor Mr. Leeson.52 In fact, the executives at Barings failed to realize that Mr. Leeson's derivatives trading was conducted on behalf of the firm, and not for any client.53 The loss of Barings illustrates the "vulnerability of . . . financial institutions to the whims of just one money manager who can manipulate huge sums of money by employing a few computer keystrokes and the notorious high-octane instruments known as derivatives."54

Thus, Barings shows us that "as more powerful technology is deployed, there's a greater need for oversight of traders and people who use computers to create new derivatives to sell to clients."55 This need cannot be met by limiting regulations solely to exchange-traded derivatives. Dealers in OTC derivatives often use exchange-traded derivatives to "hedge the risks of their OTC portfolios."56 This relationship between the two types of derivatives suggests that both must be regulated to secure market efficiency.

50Id. (quoting Jon Macaskill, a derivatives market analyst in New York).
51Sullivan & Moseley, supra note 45, at 1.
52Id.
53Going for Broke, STAR-LEDGER (Newark), Mar. 1, 1995.
54Steve Fainaru, Barings Venerable, Vulnerable, BOSTON GLOBE, Feb. 28, 1995, at 1. The current unpredictability of financial markets, the huge incentives for young traders to take risks and the failure of institutions to develop adequate safeguards all contribute to the vulnerability of financial institutions. Id.
55Hoffman, supra note 3, at D7. The author quotes Phillips Vasan, who indicates that "[t]echnology has to be supplemented by strong management." Id.
56GAO REPORT, supra note 13, at 30.
The market for interest-rate and currency derivatives exploded in the early 1980s\(^57\) as the Wall Street rocket scientists, with the aid of powerful computers, devised models and developed products that were more sophisticated, enticing and confusing.\(^58\) In the quest for more lucrative deals, financial institutions created increasingly sophisticated products.\(^59\) The financial institutions could impress their clients with the complexity of the new instruments, and investment banks saw a way to make large profits from the growing industry. Consequently, banks can generate huge fees\(^60\) because they generally have better information than the company they are dealing with. With new derivative instruments created almost every day, the sellers are challenging the ability of buyers to stay on top of what they are offered.\(^61\)

Treasurers of corporations saw a way to make a profit while managing their risk.\(^62\) They were tempted by the new financial instruments that were presented to them, and were sold on the idea of purchasing new contracts that would not only manage financial risk, but also net big profits at the same time.\(^63\) However, the huge sums of money the Wall Street banks would make — as well as the contracts’ less obvious, but nevertheless devastating, risks — were omitted from the investment banks’ sales pitch.\(^64\) "Experts on the derivatives business . . . say that in the push for profits, sellers may not have adequately looked after the customers’ needs.\(^65\)

Although the technicians who create derivatives are rocket-scientists and physicists, "many senior managers of investment firms are 'techno-phobic'" and do not understand how the instruments work.\(^66\) To

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\(^58\)See Hoffman, supra note 3, at D7; Reno, supra note 9, at A59.
\(^59\)Hu, supra note 57, at 990.
\(^60\)See GAO REPORT, supra note 13, at 29-30.
\(^61\)Roger D. Blanc, Policy Issues Presented by Derivatives Trading, 8 INSIGHTS 10 (1994).
\(^63\)Id.
\(^64\)Fromson, supra note 1, at H1. The author indicates that Wall Street earned $5 billion, while customers lost $1.3 billion. Id.
\(^65\)Id.
\(^66\)See Mulligan, supra note 49, at 1 (quoting Nicholas Horsley, co-manager of Warburg,
be sure, "some of the most sophisticated asset managers in the nation don’t properly understand derivatives which is why there’ve been such huge and unexpected losses." If someone selling the derivatives does not fully comprehend them, one wonders how a buyer can adequately assess the complexity and risks of these instruments.

In making investment decisions, shareholders seek to invest in companies with an acceptable risk strategy. Shareholders decide to invest in a firm by comparing their personal preferred levels of risk with the firms'. They will then invest in companies with a level of risk in line with their own risk tolerance. Shareholders expect that the subsequent activities of managers will be in line with this appropriate risk exposure. Using derivatives for speculation moves the firm away from this acceptable level of risk and forces the shareholders to accept increased risk without an opportunity to assess it. Accordingly, managers should consider the shareholders' view and adopt a desirable level of risk.

Essentially, the problem pertaining to shareholders arises because the decision to buy shares of a corporation is, theoretically, based on public knowledge. Unfortunately for the shareholders, information regarding the use of derivatives is not easily ascertained. Because the use of most derivatives is not subject to mandatory disclosure requirements, investors are essentially blind to a corporation’s true financial picture.

For example:

Shareholders of Procter & Gamble normally think of their risk in terms of a new toothpaste or detergent brand, launched at huge expense, which either flops or succeeds in

67Reno, supra note 9, at A59. "The largely unregulated $5 trillion derivatives market may be growing and evolving too fast for even diligent regulators to get a harness on it." Id.
68Joanne Medero et al., Investing in Derivatives: Current Litigation Issues, 8 INSIGHTS 4 (Nov. 1994).

Recent declines in the share price or net asset value of many registered investment funds have generated a number of lawsuits by aggrieved investors claiming that they were misled as to the fund’s investment objectives and/or the level of risk associated with an investment in the fund by a failure to highlight the risks attendant with the fund’s purchase of derivatives. Plaintiffs are alleging that the funds, their directors, and their financial advisers have violated various provisions of the federal securities laws, most commonly section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 11 and 12(2) of the Securities Act, and various sections of the Investment Company Act.

Id.

69See Reno, supra note 9, at A59 (suggesting that disclosure is the “cheapest and quickest way to fix financial markets”).
the supermarkets. Imagine their surprise when they found out that the company they thought was heavily into groceries lost $157 million dabbling in derivatives. Then consider that most of the nation's major corporations, many of them with lesser reputations for financial competence than an outfit like P&G, are into derivatives. 70

In an OTC contract, the dealer has more information than the end-user, who has more information than its shareholders. Therefore, it is not surprising that the general problems of informational asymmetry rise to the forefront when derivatives transactions turn sour. Nobody wants to claim responsibility for losing enormous amounts of money, and everybody seeks to shift the blame.

The shareholders of the firm attack the directors' business decision on the grounds of breach of fiduciary duties and fraud. 71 In response, the end-user, declining to admit that it made its decision without full information, sues the dealer for non-disclosure. 72 When companies start to lose money, they complain that they were not properly informed of the risks involved with the transactions. 73 The buyers "seek to void [the losing] transactions through allegations that the derivatives investment was unsuitable, certain misrepresentations were made, or that the customers lacked the authority to enter into the transaction." 74 The banks, on the other hand, allege that the buyers knew exactly what they were getting into when they signed the contract. 75 Dealers defend their activities and claim to have acted reasonably. 76 Thus begins the vicious cycle of derivatives-related litigation. 77

70 Id.
71 See Medero et al., supra note 68, at 4 (indicating that "[t]he complaints ... contain claims for common law fraud, negligence, negligent misrepresentation and breach of fiduciary duty).
72 Id.
73 Id.
74 Id.
75 See Medero et al., supra note 68, at 4 (indicating that defendants may argue that "there has been no misstatement of material fact" and that the risks have been properly explained).
76 See id.
77 This section examines only those suits related to the problems of informational asymmetries. For a more comprehensive analysis of all potential causes for litigation, see id.
A. Suits Between Dealers and End-Users

1. Negligence and Non-Disclosure

An end-user expecting large returns, but sustaining losses, may allege that the dealer who created the derivatives was negligent by failing to adequately disclose the inherent risks. For example, in 1994 Proctor & Gamble (P&G) sued Bankers Trust, asserting that the financial adviser did not accurately and fully disclose the terms and risks of the investments prepared for P&G. P&G alleged that because the risks were not disclosed, the company agreed to a transaction that exceeded its usual rules for investment risk. According to Edwin Artzt, the chairman and chief executive of P&G, Bankers Trust "called themselves the experts and encouraged P&G to enter into a transaction [it] never would have accepted had it been fully and accurately presented." As a result of the derivatives designed by Bankers Trust, P&G lost over $100 million.

In the lawsuit, P&G identifies itself as a "cautious client dependent on its financial adviser's explanations of the complex instruments." The suit noted that P&G, a company "which routinely hedges against interest-rate swings, refused other proposed Bankers Trust [derivatives] transactions as too risky." Not surprisingly, Bankers Trust maintained that it disclosed the risks to P&G's senior management. The bank also claimed that when "it repeatedly recommended that the company sell the investment," P&G

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78See supra note 68.
80Id. P&G entered into a five year swap that "had a face amount of $200 million yet carried the interest rate risk of $3 billion of bonds." Id. The level of risk was high, and compounded by the fact that because only Bankers Trust could evaluate the complex swap, P&G could not "monitor its deteriorating position." Id.
82Reports of the true amount of loss vary. See, e.g., id. (reporting the loss at $102 million); Bary, supra note 79 (reporting the loss at $130 million); Reno, supra note 9 (reporting the loss at $157 million).
83Thomas, supra note 5, at A6.
84Id. Note, however, that "former P&G employees were highly skeptical that the company that prides itself on thorough analysis would jump blindly into a large transaction without full knowledge of its exposure to losses." Id.
85P & G, supra note 81.
ignored the advice.\textsuperscript{86} Consequently, the bank asserted that its behavior was "legal, proper, and appropriate."\textsuperscript{87}

2. Misrepresentations and Fraud

End-users may allege that dealers intentionally provided false information to induce the purchase of derivatives.\textsuperscript{88} For example, both Gibson Greetings and P\&G brought charges against Bankers Trust for reckless and negligent misrepresentations.\textsuperscript{89} P\&G alleged that "[f]raud was so pervasive and institutionalized that Bankers Trust employees used the acronym ‘ROF’ — short for rip-off factor, to describe one method of fleecing clients."\textsuperscript{90} Although Bankers Trust denied making any fraudulent misrepresentations, the tape recorded conversations of the bank’s employees cast doubt on the investment bank’s sincerity.\textsuperscript{91} For example, in discussing P\&G’s agreement to enter one of the losing derivatives contracts, a Bankers Trust salesman admitted, "we set ’em up."\textsuperscript{92} Another Bankers Trust employee said to a colleague: "Funny business, you know? Lure people into that calm and then just totally f--- ’em."\textsuperscript{93}

3. [Un]Suitability

Regulations requiring dealers to sell only those securities that suit the end-users protect the end-users’ interests.\textsuperscript{94} The notion of suitability requires "that a financial advisor must refrain from recommending an investment to a customer unless the advisor believes the investment is appropriate in light of the customer’s current financial situation and objectives."\textsuperscript{95} The regulations of the National Association of Securities Dealers provide that "[w]hen a customer relies on the expert advice and opinion of the stock or bondbroker, the broker has a legal obligation not

\begin{itemize}
\item \textsuperscript{86} Id.
\item \textsuperscript{87} Id.
\item \textsuperscript{88} See supra note 68.
\item \textsuperscript{89} Baird et al., supra note 8, at 316-26.
\item \textsuperscript{90} Kelley Holland et al., The Bankers Trust Tapes, Bus. Wk., Oct. 16, 1995, at 106, 108 (quoting P\&G court filing).
\item \textsuperscript{91} See id.
\item \textsuperscript{92} Id. at 110.
\item \textsuperscript{93} Id. at 108.
\item \textsuperscript{94} Brett D. Fromson, Rules Sought for Derivative Trading: Nonprofits Ask Congress for Protection From Risky Securities, WASH. POST, Oct. 6, 1994, at D13.
\end{itemize}
to recommend risky securities.\textsuperscript{96} "When dealers sell [financial] instruments to 'unknowing' investors that are dependent on them for advice, the sellers are frequently deemed to have a fiduciary duty."\textsuperscript{97} Thus, if the nature of a particular derivatives contract is that of a security, an end-user may allege that the broker recommended a particular securities transaction, giving rise to a breach of the fiduciary duty of loyalty or care.\textsuperscript{98} As a result of a breach of fiduciary duty, the customer loses money in "unsuitable" investments.\textsuperscript{99} P&G raised this claim in its suit against Bankers Trust, but "Bankers Trust said in its answer and counterclaim that P&G was a sophisticated user of derivatives and had engaged in a series of complex transactions in recent years."\textsuperscript{100}

To support a claim that a broker owed the customer a fiduciary duty, an end-user will claim that the dealer's expertise in derivatives trading far exceeds its lack of sophistication in "complex derivative transactions."\textsuperscript{101} However, corporate management may not always be willing to prove they were not sophisticated enough to buy the latest derivatives products.\textsuperscript{102} To be sure, "some executives hesitate to pursue claims that, in essence, require them to admit that they didn't know what they were doing. As one attorney puts it: how many CEOs are going to sign a complaint that says, 'I was an idiot?'"\textsuperscript{103}

B. \textit{Suits Between the End-Users and Their Investors}

Investors have no way to determine the extent to which a firm engages in derivatives activities. They are not present during the negotiations, nor are they subsequently informed of the resulting transactions. Often, they are not aware of management's involvement with derivatives until the company sustains serious losses. When this occurs, there is some recourse for investors under the securities laws.

\textsuperscript{96}Fromson, \textit{supra} note 94, at D13.
\textsuperscript{98}See Medero et al., \textit{supra} note 68, at 4.
\textsuperscript{99}See id.
\textsuperscript{100}Bankers Trust Denies P&G's Allegations in Derivatives Suit, \textit{WALL ST. J.} Nov. 21, 1994, at B4.
\textsuperscript{101}Medero et al., \textit{supra} note 68, at 4.
\textsuperscript{102}Knecht, \textit{supra} note 97, at 1.
\textsuperscript{103}Id.
1. Breach of Fiduciary Duty

Under the Model Business Corporations Act (MBCA), directors of public companies owe a duty of reasonable care and a high degree of loyalty to the corporation. Specifically, directors and officers are required to act in good faith and exercise that degree of skill, diligence and care that an ordinarily prudent person would exercise in similar circumstances. There is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." This presumption is known as the business judgment rule. Under this doctrine, a director satisfying the rule's requirements will not be found liable for damages "no matter how unwise or mistaken [a business decision] turns out to be."

Moreover, the MBCA expressly gives directors and officers the authority to rely on the reports of persons with professional or expert competence in matters which management lacks knowledge. Therefore, managers who claim that they entered derivatives contracts without full information may open themselves up to lawsuits by shareholders; the shareholders may claim the managers were negligent by failing to act on an informed basis. In addition, the shareholders may claim that the managers breached their fiduciary duties by entering into derivatives transactions without a full understanding of the nature of the investments and the associated risks. For example, after Proctor & Gamble publicly

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105 Id.
107 Id. The business judgment rule is developed as a result of the courts' unwillingness to interfere with internal corporate policy. Id.

The American Law Institute sets forth the essence of the business judgment rule as follows:

A director or officer who makes a business judgment in good faith fulfills the duty under this Section [establishing due care] if the director or officer:
(1) is not interested . . . in the subject of the business judgment;
(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
(3) rationally believes that the business judgment is in the best interests of the corporation.

American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01(c) (1994).
110 See Knecht, supra note 97, at 1 (stating "companies, in contending that someone took
announced its derivatives transactions losses, a shareholder filed an action against P&G’s directors and financial officers claiming that the investment constituted a breach of fiduciary duty.\(^{111}\)

2. Fraud

The directors’ fiduciary duty of loyalty "prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions."\(^{112}\) Managers are prohibited from "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."\(^{113}\) In effect, any act of management which leads investors to base decisions on incorrect information is fraudulent.\(^{114}\) Shareholders may therefore file lawsuits against management alleging that inadequate disclosure of the company’s use of derivatives constituted fraud.\(^{115}\)

IV. WHERE DO WE TURN FOR CHANGE?

It is one thing to say that reform is needed, but quite another to determine how to effectuate that reform. Should Congress enact legislation? Should the SEC or CFTC impose regulations? Can the parties to OTC transactions be trusted to make the changes themselves? This section examines the viability of each alternative.

A. Legislation

Congress may be unwilling to interfere with privately negotiated OTC transactions. Freedom to contract is a longstanding principle,\(^{116}\) and

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\(^{112}\)ROBERT C. CLARK, CORPORATE LAW 141 (1986).

\(^{113}\)17 C.F.R. § 240.10b-5 (1996).

\(^{114}\)CLARK, supra note 112, at 151.

\(^{115}\)See Medero et al., supra note 68, at 4.

\(^{116}\)See, e.g., Weber v. Aetna Casualty & Surety Co., 406 U.S. 164, 179 (1972). The first part of this century saw the evolution of the doctrine of "freedom of contract" which was held by the Court during part of that time to be a part of the Fourteenth Amendment's requirement that no person be deprived of life, liberty, or property without due process of law.

Congress could be reluctant to infringe on contract rights merely because certain derivatives transactions lost large amounts of money. The improbability of congressional action is apparent. In 1994, several bills regulating derivatives markets were written on Capitol Hill, but did not make it through committee.117 It may be that "[g]etting the entire Congress to act on derivative regulation would be like expecting it to reform health care."118

B. Regulation

It is equally unlikely that regulators would impose new standards. In fact, those responsible for overseeing the financial system were among the most zealous adversaries of the proposed legislation.119 Federal Reserve Chairman Alan Greenspan maintains that constraints on the use of derivatives will result in less efficient markets.120 He cautioned that "it would be a 'serious mistake' to single out derivatives for 'tough new laws'" because of recent losses by particular corporations and municipalities.121 SEC Chairman Arthur Levitt agrees with Greenspan and maintains that "investors and not derivatives [are] to blame" for the losses.122

On the other hand, many people believe that regulation is the solution. For example, Representative Henry Gonzales, chairman of the House Banking Committee, suggests that closer federal regulation is essential to prevent the growing financial destruction caused by investments perceived as low risk.123 Despite the apparent soundness of regulating derivatives, increased administrative burdens and transaction costs may prevent the enactment of such regulation.124

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4596, 4605 ("Throughout the history of American jurisprudence, and indeed the common law itself, the individual has been free to enter into a lawful contract when, and as, he, in his own judgment, saw fit. . . . Freedom to contract has been the keystone of our free-enterprise system.").

117 Millman, supra note 3, at C2. See also Sewell, supra note 111, at 10 (discussing the attempted legislative and administrative reforms).
118 Reno, supra note 9, at A59.
119 See Millman, supra note 3, at C2. The regulators argued "that legislating controls on derivatives would cause more problems than it might solve." Id.
120 Fillion, supra note 29.
122 Fillion, supra note 29.
123 Reno, supra note 9, at A59.
124 Sheila C. Bair, Lessons From the Barings Collapse, 64 FORDHAM L. REV. 1, 10 (1995). Bair, the senior vice-president of government relations for the New York Stock
C. Inside Controls and Internal Guidelines for Disclosure

A third view holds that neither legislation nor regulation is appropriate. Because "[e]ffective corporate governance is critical to managing the risks associated with derivatives-related activities," it has been suggested that "the best way to limit derivatives risk is for banks to do it themselves." Under this view, banks should ensure the adequacy of internal controls. In addition, "[d]ealers should be certain to adequately disclose the market risk of transactions and to document their dealings with customers." Similarly, by ensuring effective risk management, corporations may be in the best position to protect themselves against shareholder litigation. End-users should establish appropriate guidelines for purchasing derivatives and adequately explain their derivatives activities in their reports to shareholders.

To some extent, dealers and end-users have begun to strengthen internal controls. "Already, post Barings, every bank in the world is reviewing its controls." For example, in an attempt to remove the traders’ incentive to make risky bets, "Salomon plan[ed] to dock some of the pay earned by proprietary traders in good years if they lose money later." Moreover, many securities firms have tried to design software programs to accurately determine the risks associated with complex derivatives. However, it must be remembered that these "programs are only as good as the people who run them and depend in large part on how vigilant the firm wants to monitor its trades."

Merely asking dealers and end-users to monitor themselves and disclose information is not enough to effectuate the necessary change. For example, Bankers Trust "introduced new procedures designed to

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Exchange, "doubt[s] that many of these proposed reforms will be implemented unless the industry itself, both firms and end-users, weigh heavily into the debate." Id.

125Medero et al., supra note 68, at 4.
126Micklethwait, supra note 3, at 1.
127Medero et al., supra note 68, at 4.
128Id.
129Id. It has been proposed that, "[t]o protect against securities fraud class actions, public companies should insure that they provide shareholders with disclosure sufficient for them to gain an adequate understanding of the company’s derivatives activities. . . . In addition to such mandated disclosure, narrative disclosure in the . . . company’s annual report and/or prospectus should be considered." Id.
130Micklethwait, supra note 3, at 1.
131Bary, supra note 79, at 31.
132Fainaru, supra note 54, at 1.
133Id.
prevent reoccurrence of a similar problem and to provide a level of disclosure and pricing transparency that will benefit [their] clients.\textsuperscript{134} Bankers Trust has stated that "[w]ith our actions, Bankers Trust has put things right, not only in this instance, but in a lasting and fundamental way."\textsuperscript{135} As the P&G losses were sustained after these procedures went into effect,\textsuperscript{136} the self-imposed measures were clearly inadequate. Moreover, as the Barings disaster illustrates:

\begin{quote}
[B]anks everywhere may lack adequate controls for guarding against flights of fancy by key members of their trading operations. Of course, Barings thought it had such controls, through internal auditing and other forms of surveillance. It simply had the bad luck to have a trader who, from all appearances, flouted the rules. It can be rather difficult to guard against that sort of thing.\textsuperscript{137}
\end{quote}

Additionally, self-governance by end-users may not be successful. As disclosure remains within management’s discretion, firms will only disclose when they are hedging. Because they will not want to discourage investors, they will have an incentive not to report speculative activities. Although shareholders may discount the amount they are willing to pay when firms do not disclose, the discount will not offset management’s benefit from nondisclosure.

V. PROPOSED REGULATIONS

Legislation will be impossible; self-governance will be ineffective. Thus, despite strong resistance to the regulation of derivatives, it is the only way to protect the interests of both end-users and their investors. It is no secret that requiring mandatory disclosure aids in correcting the problems caused by informational asymmetry.\textsuperscript{138} The essence of the

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\textsuperscript{134}Bankers Trust Settles Derivative Charges, CHL TRIB., Dec. 23, 1994, at 1 (quoting Charles S. Sanford, Jr., Bankers Trust chairman). Bankers Trust introduced this procedure as a result of SEC charges indicating that Bankers Trust committed fraud on its dealings with Gibson Greetings Corporation. \textit{Id.} Bankers Trust paid $5 million to the SEC and $5 million to the Commodity Futures Trading Commission to settle the charges. \textit{Id.}
\textsuperscript{135}\textit{Id.}
\textsuperscript{136}See Bary, \textit{supra} note 79, at 31.
\textsuperscript{138}The need to protect investors from informational asymmetries has been identified in the past. To be sure, the purpose of the Securities Exchange Act of 1934 is to assure that
\end{footnotesize}
policy behind "federal securities laws involves the remediation of information asymmetries."\textsuperscript{139} Not only are corporations required to issue annual and quarterly reports,\textsuperscript{140} but brokers are also subject to reporting requirements.\textsuperscript{141} Regulation will solve the problems that stem from the informational gaps involved with derivatives.

A. Mandatory Disclosure by Banks

"Federal regulators are closely scrutinizing the derivatives operations of banking organizations and are prepared to take enforcement actions against those whose sales practices are questionable."\textsuperscript{142} For example, in December 1994 the Federal Reserve Board entered into a "first-of-its-kind enforcement agreement" with Bankers Trust, requiring the bank to provide customers with sufficient information to understand the nature and risks associated with the derivatives.\textsuperscript{143} The agreement provides that "Bankers Trust shall conduct its leveraged derivatives transactions business in a manner which seeks to reasonably ensure that each leverage derivatives transaction customer has the capability to understand the nature and material terms, conditions and risks of any leveraged derivatives transaction entered into with the customer."\textsuperscript{144}


\textsuperscript{140}\textit{See id.} at 649-50. The information required to be included in the annual report is included in Form 10-K. \textit{See LOSS & SELIGMAN, supra} note 138, at 1854-65. The information required for quarterly reports is governed by Form 10-Q. \textit{Id.} at 1864-71.

\textsuperscript{141}Under Rule 10b-10, 17 C.F.R. § 240.10b-10 (1994), brokers are required to provide confirmation statements and other reports to securities customers. \textit{See Seligman, supra} note 142, at 650 n.7.

\textsuperscript{142}\textit{Fed Takes First Action Against Bank on Derivatives Sales}, 13 \textit{Banking Pol'y Rep.} 6 (1994).

\textsuperscript{143}\textit{Id.}

\textsuperscript{144}\textit{Id.}
Bankers Trust must emphasize and inform its customers about the risks of derivatives contracts. Moreover, Bankers Trust must adopt practices which ensure "reasonable transparency of pricing and valuation" so that customers can track the daily values of the complex instruments.

Bankers Trust also entered into an agreement with the SEC and CFTC. Under this agreement, the securities branch of Bankers Trust, BT Securities, agreed to pay $5 million to the SEC and $5 million to the CFTC without admitting or denying any wrongdoing. Actions taken by regulators against Bankers Trust indicate the willingness "to subject derivatives [transactions] to the same rules as securities and commodities frauds." Because other securities are subjected to mandatory disclosure requirements, the ad hoc imposition of penalties is an inadequate measure to protect end-users. Therefore, regulations modeled after the Federal Reserve Board's enforcement agreement should be adopted.

B. Stricter Monitoring of Banks' Internal Controls

Many of the recent losses attributed to derivatives occurred because of lax supervision by management. In order to prevent similar failures in the future, regulators must require investment banks to adopt strict plans for supervising management. To ensure the proper oversight of employees in the derivatives business, the following regulations should be implemented.

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145 Id.
146 Fed Takes First Action, supra note 142.
147 See Bankers Trust Settles, supra note 134, at 1.
148 Id.
149 Millman, supra note 3, at C2.
150 See Singher, supra note 37, at 1421.

Both the Office of the Comptroller of the Currency ("OCC") and the Federal Reserve Board ("FRB") also have substantial power to affect the use of derivatives. Whereas the SEC and CFTC arguably have direct statutory jurisdiction over many derivative instruments, the OCC and the FRB affect derivatives through governance of banks in the United States. Because banks are a principal user of derivative products, requirements the OCC and FRB impose upon the banking industry have the potential to widely affect derivative instruments.

Id. at 1426-27. This author does not deny that the Federal Reserve Board has the potential to widely affect derivatives. Rather, this author believes that imposing enforcement actions after abuses occur is insufficient.

151 See Bankers Trust Settles, supra note 134, at 1.
152 See, e.g., Heberlin, supra note 32, at F1 (discussing the Barings incident).
Management shall ensure that periodic audits are conducted.
Management shall be responsible for the oversight and control of the structuring of individual derivatives transactions.
Supervisors and managers shall conduct periodic performance evaluations of employees involved in the derivatives transaction business.
Senior management shall be responsible for the oversight and performance evaluation of managers of the derivatives business.
Managers shall monitor the derivatives activities of the bank, and correct any weaknesses and deficiencies.\textsuperscript{153}

C. \textit{Mandatory Disclosure by Management}

Although shareholders receive some protection from securities laws, the existing regulations are insufficient to insulate investors from unwanted risk. It is imperative that investors be able to make informed decisions, and mandatory disclosure is the only way to achieve this objective. The SEC is not involved in regulating derivatives as its main goal is to protect shareholders.\textsuperscript{154} In modern economic times, however, regulation is necessary to protect shareholders from undisclosed derivatives activity. The SEC should require buyers of derivatives to adequately explain their activities to shareholders. In this way, the interests of the shareholders are guarded. To this end, the SEC should consider adopting the following regulations:

- The annual report to the shareholders shall contain a section detailing the company's derivatives activities during the past year. The company shall characterize the nature of its activities as either speculative or hedging.
- Any changes in derivatives activity shall be included in the quarterly report filed by the company with the SEC.

\textsuperscript{153}These proposed regulations are modeled in large part after the Federal Reserve Board's enforcement agreement with Bankers Trust. \textit{See Fed Takes First Action, supra} note 142, at 6.

\textsuperscript{154}\textit{GAO Report, supra} note 13, at 85.
Management shall include a narrative of the corporation's exposure to derivatives in the MD&A [Management Discussion and Analysis of financial condition] section of the company's annual reports.155

The additional information required by these regulations will increase market efficiency and enable shareholders to assess risks more accurately.

VI. CONCLUSION

Derivatives are important tools for effective risk management in our global economy. However, the rapid growth of the derivatives market has created the potential for abuse. Dealers on Wall Street have responded to the growing market by creating more complex instruments to impress end-users and earn huge fees through sales. End-users buy the instruments relying on the seller's knowledge and expertise.

The fact that the dealer has more information than the end-user is inherent in the nature of the transactions. Consequently, the end-user will sue the dealer if the transaction proves unfavorable. The end-user will claim a lack of information, or incorrect information, and will accuse the dealer of fraud and misrepresentation. In turn, the end-user's shareholders will sue management for entering risky transactions in violation of various securities laws.

Regulation is necessary to prevent this cycle of litigation. Banks must be required to disclose the risks and nature of derivatives to end-users. Further, this disclosure must be recorded so that the end-user cannot subsequently claim that it did not fully understand the risks. Similarly, corporate management engaging in derivatives transactions must be required to fully disclose derivatives activities to shareholders. Only when regulation is accomplished will dealers, end-users, and shareholders be fully protected.

155 These proposals are based on suggestions provided by Medero, supra note 68.