ARTICLES

THE SHIFTING CONTOURS OF GLOBAL DERIVATIVES REGULATION

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1. INTRODUCTION

This paper considers efforts to regulate (and to prevent the regulation of) the \$100 trillion-plus global market for financial derivatives.¹ It divides the universe of derivatives regulation into four categories of rule making—statutory, judicial, private, and arbitral—and proposes changes within each category.

First, the greatest source of uncertainty in the derivatives market is the complex web of statutory regimes that govern (or do not

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¹ Derivatives are financial instruments, such as options and forward contracts, whose value is derived from some underlying instrument or index. For a detailed description of the classes and uses of derivatives, see Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 216-27 (1997) [hereinafter Partnoy, *Regulatory Arbitrage*]. Derivatives may be traded on an exchange or over-the-counter ("OTC") in private transactions. The Bank for International Settlements ("BIS") has estimated that the size of the OTC derivatives market in notional amounts as of year-end 1999 was approximately \$83.2 trillion. See Press Release, Bank for International Settlements, *The Global OTC Derivatives Market at End-December 1999* (May 18, 2000), at <http://www.bis.org/press/p000518.htm>. Interestingly, the gross market values of these contracts has declined dramatically from 4.02% of the notional amounts at year-end 1998 to 3.19% of the notional amounts at year-end 1999, a decline of more than 20%. See *id.* This decline in market value may be a sign of very large losses in the industry during 1999, a fact that is very difficult to ascertain. Trading in OTC derivatives is highly concentrated, with the world's ten largest banks accounting for almost 90% of OTC derivatives activity worldwide. ALFRED STEINHERR, *DERIVATIVES: THE WILD BEAST OF FINANCE* 155 (rev. ed. 2000). The BIS also has estimated that the OTC derivatives market comprises approximately 86% of the overall derivatives market. *Id.* at 152-53. Estimates of the size in notional amount of the exchange-traded derivatives market are in the \$13 to \$14 trillion range. *Id.* at 153. Hence, the total size in notional amount of the derivatives industry is greater than \$100 trillion.

govern) the purchase and sale of derivatives. Derivatives are regulated by multiple laws under multiple regulatory jurisdictions. Many classes of derivatives are not regulated at all. Many pockets of the derivatives market exist precisely *because* of the range of nonsensical and costly statutory applications, as a result of so-called "regulatory arbitrage" transactions. It is increasingly difficult to determine whether, under the applicable tests, a particular instrument is a "security," a "future," or neither. Derivatives may be economically equivalent to securities or futures but fit under different statutory regimes or none at all. Competition between the regulatory regimes has not led to the efficiencies predicted by scholars who advocated expanded regulatory competition. To the contrary, competition has led to an inefficient turf battle and costly uncertainty. In late December 2000, Congress passed legislation permitting trading of individual stock futures and clarifying certain swap exemptions. I will explain some of this legislation's drawbacks.

Second, because many derivatives contracts are outside the scope of federal statutory regimes, courts—often state courts—are beginning to decide complex derivatives disputes based on common law principles. I argue that such common law adjudication has failed in several ways. It is extraordinarily expensive to resolve these disputes, and there are few published decisions to guide future parties. Facts are difficult to ascertain, and complaints and judicial opinions often do not accurately describe the underlying transactions. Jurisdictional battles are fierce and costly. Documents are not available or are under seal, and much important evidence is destroyed or is otherwise unavailable by the time discovery begins. The result is an expensive, inefficient, unfair, and uncertain process. I analyze and critique several recent derivatives disputes in which judges have attempted to apply state common law principles (e.g., breach of fiduciary duty, fraud, lack of authority).

Third, derivatives dealers have created a robust system of private law embodied in the standard form contracts used in the over-the-counter derivatives transactions. I argue that these contracts are structured to ensure that the transactions are neither subject to federal regulation nor susceptible to challenge under state common law. I criticize the standard form contract created by the International Swap Dealers Association ("ISDA") and argue that non-

reliance provisions (i.e., disclaimers) in such contracts should provide only narrow protection to dealers and should not preclude claims based on inaccurate or misleading material representations or omissions by dealers.

Fourth, given the problems associated with the alternative means of resolving disputes, one might expect derivatives counterparties to agree to resolve disputes through arbitration. Yet arbitration of such disputes is rare. One reason may be that derivatives sellers fear the uncertainty associated with an arbitrator even more than they fear a judge. Another reason may be that dealers prefer the courts precisely because they are more expensive. In court, a dealer can force a plaintiff to engage in expensive litigation, which the dealer easily can afford but which the plaintiff may find more difficult to sustain (at a typical cost of several hundred thousand dollars per month). Dealers also benefit from delay. I attempt to explain why so few derivatives disputes are resolved in arbitration, and I suggest circumstances under which arbitration might be preferable.

Section 2 frames the discussion by describing the general difficulties associated with line-drawing in the global derivatives market. Section 3 specifically analyzes the four approaches to regulation. The \$100 trillion market for financial derivatives is subject to piecemeal statutory regulation, or none at all (as described in Section 3.1.), and the development of common law in this area has been slow and sporadic (as described in Section 3.2.). Private contracting, while extensive, has failed to ameliorate these problems (as described in Section 3.3.). Private parties who have specified arbitral rules in advance are subject to even less certainty than parties with disputes resolved based on common law (as described in Section 3.4.). Section 4 suggests and assesses a proposal for a system that might avoid some of the problems of existing regulatory approaches by having parties agree *ex ante* to be bound by hypothetical cases specified in their contracts (i.e., synthetic common law).

2. LINE-DRAWING IN THE GLOBAL DERIVATIVES MARKET

Derivatives are notoriously difficult to categorize. Part of the problem is the ambiguous meaning of the term “derivative.” The

definition typically² given by legal academics and commentators in the area is not particularly helpful: a derivative is a financial instrument whose value is based on (or "derived" from) some underlying instrument or index.³ According to this definition, nearly all financial instruments are derivatives.⁴

In more precise economic terms, derivatives include two basic classes of instruments: options and forwards. Both are financial contracts, the primary difference being that options are "rights," whereas forwards also include "obligations."⁵

For example, a call option is the *right* to buy some underlying instrument at a specified time and price.⁶ An investor might purchase a call option on IBM stock with an exercise price of \$100 and an exercise date of one year from today. Such an investor would have the right, but not the obligation, to buy IBM stock during the next year for \$100. If the price of IBM increased, the value of the call option also would increase. If after one year the price of IBM were below \$100, the option would expire worthless.

In contrast, a forward is the right and the *obligation* to buy or sell some underlying instrument at a specified time and price. A baker might buy a forward contract on a bushel of wheat with a forward price of \$100 and a delivery date of one year from today. In this case, if the value of the wheat increased the baker would make money on the forward contract, and these gains would offset the increase in the cost of the higher-priced wheat. Conversely, if the value of the wheat decreased the baker would lose money on the forward contract, but these losses would be offset by gains associated with buying lower-priced wheat.

² The popular definition is not used by regulators, who define derivatives in increasingly obtuse and nonsensical ways. See *infra* Section 3.1.

³ See, e.g., Partnoy, *Regulatory Arbitrage*, *supra* note 1, at 212 n.2 (discussing various definitions of derivatives).

⁴ Even stocks and bonds can be thought of as derivatives. See generally Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 637 (1973) (describing equity as a call option).

⁵ See Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599, 604, 607 (2000) [hereinafter Partnoy, *Corporate Law Mix*].

⁶ Whereas a call option is the right to buy, a put option is the right to sell. For a detailed and colorful description of the various option payouts, including diagrams, see Peter H. Huang, *Teaching Corporate Law from an Option Perspective*, 34 GA. L. REV. 571 (2000).

There are additional complexities to derivatives.⁷ The purchaser of the call option in the previous example could purchase the option either through an exchange or from another private party.⁸ Similarly, the baker could purchase a forward contract either through an exchange (in which case it would be called a future) or from another private party. In addition, the simple examples of options and forwards can be combined in all sorts of complicated and fantastic ways.⁹ Many derivatives are off-balance sheet and thus escape scrutiny.¹⁰

In the option example, the investor was using derivatives to speculate on the price of IBM stock. In the forward example, the baker was using derivatives to hedge the risk of an increase in the

⁷ The existence of derivatives means that traditional financial market labels—such as “equity” and “debt”—are now potentially meaningless. For example, suppose a particular legal rule applies only to the “equity” of a firm. Examples include the duties of care and loyalty, which the managers of a firm generally owe to the firm’s shareholders (e.g., equity), but not to the firm’s other stakeholders (e.g., debt). However, what constitutes “equity” may vary from firm to firm in ways that make the legal rules inconsistent. See Partnoy, *Corporate Law Mix*, *supra* note 5, at 608-16.

⁸ The private transaction is classified as OTC.

⁹ For examples of exotic derivatives and the complexities of the valuation issues associated with them, see PAUL WILMOTT, *DERIVATIVES: THE THEORY AND PRACTICE OF FINANCIAL ENGINEERING* 34-41 (1998). Even complex combinations of options and forwards may not create “complete” markets. See Peter H. Huang, *A Normative Analysis of New Financially Engineered Derivatives*, 73 S. CAL. L. REV. 471, 498-500 (2000). More complex derivatives generally are more profitable for the derivatives dealers who sell them. See, e.g., STEINHERR, *supra* note 1, at 160 (“More complicated products are more profitable and therefore more attractive to dealers.”). Financier George Soros has expressed unease about the dangers in complex aspects of the derivatives market:

The explosive growth in derivative instruments holds other dangers. There are so many of them, and some of them are so esoteric, that the risks involved may not be properly understood even by the most sophisticated of investors. Some of these instruments appear to be specifically designed to enable institutional investors to take gambles which they would otherwise not be permitted to take And some other instruments offer exceptional returns because they carry the seeds of a total wipeout.

GEORGE SOROS, *SOROS ON SOROS* 313-14 (1995).

¹⁰ See STEINHERR, *supra* note 1, at 159 (describing off-balance sheet treatment and noting that for major commercial banks, including Chase Manhattan and Morgan Guaranty, the notional value of off-balance sheet derivatives represents forty to fifty times the value of their balance sheet assets).

cost of wheat. Speculating and hedging are two of the primary uses of derivatives.¹¹

A third use of derivatives—arbitrage, including regulatory arbitrage—presents additional difficulties. True arbitrage is the simultaneous, riskless purchase and sale of economically equivalent instruments for profit. True arbitrage rarely exists, but derivatives frequently are used to make arbitrage-like bets that economically similar instruments will converge in price. These bets are variously known as risk arbitrage, convergence trades, or relative value trades.

A particular type of arbitrage, regulatory arbitrage, involves the use of derivatives to avoid costly regulation. Regulatory arbitrage involves purchases and sales of financial instruments designed to capture the difference in regulatory costs applicable to two economically equivalent assets.¹² Private parties often use derivatives for regulatory arbitrage, a fact that makes the job of defining derivatives more difficult, especially for regulators, because to the extent a regulatory cost is imposed on a class of instruments, there is an incentive for market participants to create economically equivalent derivative assets that avoid the regulatory cost.

Disputes in the financial market have involved all three uses of derivatives. The disputes have occurred in waves, typically after some major economic dislocation (e.g., an increase in interest rates or dramatic change in foreign exchange rates) causes market participants to sustain losses large enough to lead them to sue. Not all derivatives losses are relevant here.¹³ An early round of deriva-

¹¹ See, e.g., Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani-Miller Forty Years Later*, 1998 U. ILL. L. REV. 1039 (hedging); Lynn A. Stout, *Betting the Bank: How Derivatives Trading Under Conditions of Uncertainty Can Increase Risks and Erode Returns in Financial Markets*, 21 J. CORP. L. 53 (1995) (speculating).

¹² See generally Partnoy, *Regulatory Arbitrage*, *supra* note 1, at 216-27 (describing the classes and uses of derivatives). For example, a simple regulatory arbitrage transaction could involve buying an untaxed asset and selling an economically equivalent taxed asset.

¹³ For example, although one publicized case, involving billion dollar losses by Nicholas Leeson of Barings Bank, has raised numerous regulatory and policy issues about derivatives, the Barings losses are not relevant here, because the losses did not involve a dispute between the purchaser and seller of the financial contracts. It is worth noting, however, that in December 1995 a Singapore court sentenced Nick Leeson to six and a half years in prison for fraud and for falsifying certain reports sent to SIMEX, the relevant exchange in Singapore. See Michael S.

tives losses, which led to the first major wave of derivatives cases, followed soon after when the Federal Reserve increased interest rates six times in early 1994.¹⁴ Another wave followed the Asia crisis of 1997, when several Asian currencies collapsed.¹⁵

Before 1994, numerous companies throughout the world had purchased derivatives contracts, including swap transactions, that essentially were bets that short-term rates would remain low. There were numerous ways to place this bet using derivatives. The most straightforward way would have been either to enter into a simple interest rate option or forward contract,¹⁶ betting that rates would not increase. Another would have been to enter into a simple U.S. dollar interest rate swap, pursuant to which the company would agree to pay a short-term floating interest rate and to receive a fixed interest rate, each as a percentage of some fixed, notional amount.

For example, if in 1993 Procter & Gamble ("P&G") had believed interest rates would remain low (or if it had wanted to convert fixed rate liabilities into floating rate liabilities), it could have entered into an interest rate swap transaction with Bankers Trust, agreeing to pay every three months a short-term floating interest rate (e.g., LIBOR, the London Inter-Bank Offered Rate) times \$100 million and to receive, say, 5% of \$100 million, or \$5 million. Then, if interest rates remained low, P&G would make money every quarter on its swap; if interest rates increased, it might lose money.

Such swaps, known as "plain vanilla" interest rate swaps, are very common, are relatively low risk, and are transacted in a competitive, transparent market.¹⁷ Unfortunately for the banks bro-

Bennett & Michael J. Marin, *The Casablanca Paradigm: Regulatory Risk in the Asian Financial Derivatives Markets*, 5 STAN. J.L. BUS. & FIN. 1, 5 (1999).

¹⁴ These increases followed an extended period during which short-term U.S. interest rates had remained very low. During that period, many market participants made short-sighted bets that these rates would remain low based on historical performance.

¹⁵ These collapses followed an extended period during which Asian foreign exchange rates were very stable. During that period, many market participants made short-sighted bets that these rates would remain stable based on historical performance.

¹⁶ Interest rate option and forward contracts are traded on exchanges, whereas many of the transactions underlying the derivatives disputes during this period were based on similar OTC transactions.

¹⁷ See generally STEINHERR, *supra* note 1, at 154 (discussing the benefits of plain vanilla instruments).

kering such swaps, the large size and competitive nature of that market means that such swaps are a relatively unattractive low-margin business. The greatest growth in derivatives has been in swaps and other OTC derivatives, whereas "plain vanilla" trades have become less profitable in recent years.¹⁸

However, derivatives disputes, especially those involving large, well-publicized losses, typically do not involve these simple financial contracts. Instead, they more often involve more complex swaps and structured transactions, which are neither liquid nor transparent and which generate very large profits for dealers.

In sum, although derivatives are difficult to categorize, derivatives disputes typically have involved transactions that were both, on average, more complex for the purchaser and more profitable to the seller. Frequently, these transactions were composed of several simpler parts, which could have been sold separately in a small number of more straightforward transactions. "Plain vanilla" transactions are rarely disputed.

3. FOUR APPROACHES TO GLOBAL DERIVATIVES REGULATION

Thus far, I have described only the economic complexities of financial derivatives, without mentioning the applicable regulatory regimes. Unfortunately, these regimes do not track the economic attributes of derivatives and often seriously contradict them.¹⁹

The result is that the derivatives market is fraught with uncertainty.²⁰ Frank Knight has distinguished between risk (which has an observable probability distribution) and uncertainty (which does not).²¹ Markets deal well with risk but not with uncertainty. Some investors (in some instances including sophisticated deriva-

¹⁸ See STEINHERR, *supra* note 1, at 161 (noting increase in use of OTC derivatives by non-financial institutions from \$7.5 trillion in 1995 to \$11 trillion in 1998).

¹⁹ This regulatory tension creates additional incentives for regulatory arbitrage transactions.

²⁰ See Kathleen Day, *The Derivatives Dilemma: Oversight Dispute Leaves Contracts in Perilous Limbo*, WASH. POST, June 2, 2000, at E2 (describing the legal status of derivatives as "murky"); Michael Schroeder, *Lugar in Senate Charges CFTC, SEC Impede Bill to Deregulate Derivatives*, WALL ST. J., June 22, 2000, at C26 (describing current legal and regulatory uncertainty and legislation proposed to reduce it). See generally Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431 (1991) (discussing uncertainty in regulation of new financial products).

²¹ See FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* ch. 7 (1921).

tives market participants) face uncertainty in valuing complex derivatives.²² Others understand derivatives well enough to evaluate their market risks but face uncertainty in assessing other aspects of the transactions, including potential liability in a future dispute. Much of the uncertainty in the derivatives market stems from regulation, and the OTC markets are among the least certain.

This Section assesses how the four regulatory alternatives have addressed derivatives disputes (or have failed to do so). Statutory coverage is piecemeal, byzantine, and has led market participants to opt out of the statutory framework when dealing in the OTC markets. The common law, then, has been left to resolve these disputes, and it has performed abysmally. Private law has worked to insulate market participants from regulatory coverage and, potentially, from liability in disputes but has failed to clarify transaction terms relevant to disputes. Arbitration has played only a limited role and has provided even less certainty.

3.1. *Piecemeal Regulation of Derivatives by Statute*

The greatest source of uncertainty in the derivatives market is the complex web of statutory regimes that govern (or do not govern) derivatives purchases and sales. Derivatives are regulated by multiple laws under multiple regulatory jurisdictions.²³ Many classes of derivatives are not regulated at all. Many pockets of the derivatives market exist precisely *because* of the range of nonsensical and costly statutory applications. This Section is an attempt to explain some of the different aspects of those statutory regimes.

There are two primary sets of federal statutes²⁴ and agencies regulating derivatives.²⁵ First, the Securities and Exchange Com-

²² See STEINHERR, *supra* note 1, at 191-92:

There are significant difficulties in understanding, pricing and managing inherently complex derivative instruments, particularly longer-dated instruments, for example currency options. The statistical and mathematical techniques that underlie pricing and trading strategies are based on the assumption that historical distributions of price changes are good guides to future volatility. Uncertainty about the value of derivative positions may lead to liquidation sales in declining markets

Id.

²³ See, e.g., HAMILTON ET AL., A GUIDE TO FEDERAL REGULATION OF DERIVATIVES 9 (1998).

²⁴ Not all derivatives disputes with federal statutory claims involve either of these two statutes (the securities and commodities statutes). Plaintiffs in recent

mission ("SEC") regulates "securities"²⁶ (which include stocks, bonds, and options), pursuant to the 1933 Securities Act²⁷ and 1934

derivatives disputes have alleged other novel theories, even including violations of the Racketeer Influenced and Corrupt Organizations Act ("RICO"). These allegations were made together with allegations of common law fraud. See *Sumitomo Copper Swaps Complaint Seeks \$1.5B from Chase Manhattan*, DERIVATIVES LITIG. REP., Jan. 24, 2000, at 6 (noting the inclusion of a RICO claim). One leading derivatives case was decided under the Employee Retirement Income Security Act ("ERISA"). In that case, *Laborers National Pension Fund v. American National Bank & Trust Co.*, 173 F.3d 313 (5th Cir. 1999), cert. denied, 528 U.S. 967 (1999), the Fifth Circuit ruled that a pension fund's investment in Interest Only ("IO") strips did not violate the prudent investment standards contained in ERISA. See *Trying to Recoup Losses, Fund Fails to Win Sup. Ct. Review*, SEC. LITIG. & REG. REP., Jan. 12, 2000, at 6. Laborers National Pension Fund ("LNPF") lost \$4.2 million on IOs it bought from American National Bank. LNPF sued in the Northern District of Texas, and the district court found the investments violated ERISA and awarded damages of \$7.1 million. However, the Fifth Circuit reversed, holding that although IOs are volatile, they were only 6.5% of the fund's portfolio and served to hedge other portions of the fund. See *id.*

²⁵ Other federal agencies, including the Federal Reserve Board, also play a role in the regulation of derivatives. Most prominently, the Fed plays an active role in system-wide concerns about risk, as it did in the recent near-collapse of hedge-fund Long-Term Capital Management. See Peter H. Huang, Kimberly D. Krawiec & Frank Partnoy, *Derivatives on TV: A Tale of Two Derivatives Debacles in Prime-Time*, 4 THE GREEN BAG 257, 262 (2001). The U.S. Department of Treasury also plays an important, although often informal, role. The "Treasury Amendment"—though not explicitly directed at the U.S. Treasury—expressly excludes certain financial instruments from the scope of federal commodities regulation. The Treasury Amendment provides that

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

7 U.S.C. § 2(ii) (1994); see also Net Capital Rule, 50 Fed. Reg. 42,961, 42,963 (Oct. 23, 1985) (to be codified at 17 C.F.R. pt. 240) (CFTC interpretation of Treasury Amendment). The Treasury Amendment arguably exempts from regulation certain types of derivatives, including swaps.

²⁶ There is substantial uncertainty surrounding the definition of "security." The question of whether a particular financial contract is a "security" (and therefore falls within the ambit of federal securities law) typically turns on judicial interpretation of the relevant federal statutes. In the 1933 Securities Act, Congress defined the term "security" as

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate,

Securities Exchange Act.²⁸ Second, the Commodity Futures Trading Commission ("CFTC") regulates "futures"²⁹ (which include exchange-traded futures on various commodities, instruments, and indices)³⁰ pursuant to the Commodity Exchange Act.³¹ Many of the conflicts in derivatives regulation stem from the turf battle between the SEC and CFTC created by these two statutory regimes.³²

Generally, such a bifurcated regime is problematic. It is increasingly difficult to determine whether, under the applicable tests, a particular instrument is a "security," a "future," or nei-

certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1).

The definition in the 1934 Securities Exchange Act is virtually identical to the definition in the 1933 Act and courts have held that the 1933 and 1934 Acts cover the same instruments. *See* 15 U.S.C. § 78c(a)(10); *see also* *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (holding that demand notes were "securities" under the 1933 and 1934 Securities Acts).

²⁷ 15 U.S.C. § 77.

²⁸ *Id.* § 78c.

²⁹ An additional wrinkle is added by the fact that the CFTC also has exclusive jurisdiction over option transactions involving commodities. *See* 7 U.S.C. § 2(a)(i) (granting the CFTC exclusive jurisdiction over "accounts, agreements (including any transaction which is of the character of . . . an 'option' . . .), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange, or market . . .").

³⁰ Congress passed the Commodity Exchange Act and amended it to establish the CFTC in 1974, in response to widespread abuses in commodity futures trading and to protect investors amid "the volatile and esoteric futures trading complex." *CFTC v. Schor*, 478 U.S. 833, 836 (1986) (quoting H.R. REP. NO. 93-975, at 1 (1974)).

³¹ 7 U.S.C. § 2 (2001).

³² The lines between regulatory areas in the United States often are less than clear. For example, a "futures contract" may only be traded on a designated exchange, but a "forward contract"—even if it is economically equivalent—may be traded off-exchange or OTC. *See* Willa E. Gibson, *Are Swap Agreements Securities or Futures?: The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. CORP. L. 379 (1999).

ther.³³ Regulated derivatives may be economically equivalent but fit under different statutory regimes.³⁴ Competition between these two regimes has not led to the efficiencies predicted by scholars who advocate expanded regulatory competition.³⁵ To the contrary, competition has led to a nasty and inefficient "turf battle" and costly uncertainty.³⁶

Consider, for example, the regulation of forward contracts on individual stocks or bonds. The SEC and CFTC have disagreed about this issue for decades. The SEC claimed that it should have jurisdiction because such contracts behave like the underlying individual stocks and bonds; the CFTC claimed it should have jurisdiction because such contracts behave like futures.³⁷ For such contracts, it was unclear which, if any, regulatory regime applied, and competition between the two relevant jurisdictions had only in-

³³ Consider, for example, an unusual type of derivative instrument called a "viatical settlement." The purchaser of a viatical settlement pays cash upfront for an interest in the life insurance policy of a terminally ill person, typically a victim of AIDS. The price of the viatical settlement is discounted depending on the life expectancy of the insured. When the insured dies, the investor receives a share of the insurance proceeds. The courts have struggled with the question of whether viatical settlements are "securities," ultimately relying on the *Howey* test, which holds that an investment contract is a security if investors purchase with an expectation of profits arising from a common enterprise that depends upon the efforts of others. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). In 1996, the D.C. Circuit held, over a vigorous dissent by Judge Wald, that viatical settlements were not securities. The reasoning was that although they are purchased with an expectation of profits arising from a common enterprise, those profits did not depend upon the "efforts of others," because the intermediaries selling the contracts performed only ministerial services and, instead, it is the length of the insured's life that is of overwhelming importance to the value of the viatical settlements. See *SEC v. Life Partners Inc.*, 87 F.3d 536, 542-48 (D.C. Cir. 1996).

³⁴ Even relatively straightforward regulatory regimes present complex and intractable questions. For example, the task of matching purchase and sale transactions for the purpose of calculating liability under Section 16(b) of the Securities Exchange Act, 15 U.S.C. § 78p(b), becomes enormously complicated once derivatives are included. See *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316 (2d Cir. 1998) (finding that Dow Chemical's delivery of Magma Power stock was not eligible for 16(b) purposes where the stock was delivered pursuant to the exercise of subordinated exchangeable notes Dow Chemical previously had issued; the notes gave the noteholder the option to exchange the notes at any time prior to maturity for a fixed number of Magma Power shares).

³⁵ See *Russo & Vinciguerra*, *supra* note 20.

³⁶ *Id.* at 1434-35.

³⁷ See, e.g., *Day*, *supra* note 20, at E1 (describing turf battles between the SEC and CFTC since 1982).

creased uncertainty and paralyzed the markets for those instruments.³⁸ In fact, the only resolution to the dispute was a Congressional ban on futures contracts for individual stocks and bonds; such contracts became illegal and unenforceable.³⁹ In other words, options on single securities were allowed; futures on single securities were not.⁴⁰ Efforts to remove the ban provoked heated debate.⁴¹ In this area, regulatory competition did not lead to efficient results; it forced a stalemate.

Over time, exceptions were carved out of this ban against futures trading of individual stocks and bonds. There were exceptions for futures on government securities, including U.S. Treasury bonds and futures on broad-based equity indices, including the Standard & Poor's 500 Index.⁴² Other "illegal" futures were traded in the OTC market.⁴³ In other words, regulation banning the trading of these instruments created a gray market in economically equivalent OTC derivatives transactions. This gray market was not trivial. By 2000, the market for equity swaps was several trillion dollars.⁴⁴

Finally, on December 15, 2000, Congress passed the Commodity Futures Modernization Act ("CFMA"),⁴⁵ which lifted the ban on

³⁸ See *id.*

³⁹ The Commodity Exchange Act provides that it is unlawful to enter into a commodity futures contract that is not made "on or subject to the rules of a board of trade . . . located outside the United States . . . unless such transaction is conducted on or subject to the rules of a board of trade which has been designated . . . by the Commission as a contract market . . . for such commodity." 7 U.S.C. § 6(a) (2001).

⁴⁰ See *Bd. of Trade of Chicago v. SEC*, 187 F.3d 713, 716 (7th Cir. 1999) (noting that "[t]his allocation appears to be a political compromise; no one has suggested an economic rationale for the distinction.").

⁴¹ See SEC's Levitt Sees "Gaping Loophole" in Senate Bill 2697, 6 DERIVATIVES LITIG. REP., July 3, 2000, at 9.

⁴² See Day, *supra* note 20, at E1.

⁴³ The creation of such instruments is another example of regulatory arbitrage. See Partnoy, *Regulatory Arbitrage*, *supra* note 1, at 227.

⁴⁴ *An Introduction to Risk Management in Corporate Finance*, at <http://www.mellon.com/inst/mcf/derivatives/services.html>. In an equity swap, one counterparty agrees to receive (and the other agrees to pay) the increase in value of a particular stock or stocks and, in exchange, that counterparty agrees to pay (and the other agrees to receive) a specific periodic payment, typically based on some fixed or floating interest rate.

⁴⁵ Commodity Futures Modernization Act, S. 2697, 106th Cong. (2000); H.R. 4541, 106th Cong. (2000).

trading of single-stock futures. Single-stock futures are likely to begin trading soon on U.S. exchanges.⁴⁶ It remains unclear whether the regulatory structure now governing trading of these instruments will succeed. In any event, the historical lesson is that "regulatory competition" froze trading in a major asset class for two decades and created incentives for parties to engage in derivative trades that were economically equivalent to those assets.

Market participants also created large classes of OTC derivatives to fill gaps in other CFTC regulation. The CFTC requires that any CFTC-regulated financial contracts be traded on a CFTC-regulated exchange,⁴⁷ and Congress allows the CFTC to create a list of forward contracts that could be excluded entirely from CFTC regulation (and that therefore were not required to be traded on a CFTC-regulated exchange). Today, such forward contracts are traded in the OTC market and include some of the largest markets in the world, such as the market for interest rate and currency swaps.

Derivatives traded in these OTC markets would remain legal so long as the CFTC keeps those trades on its list of exempt contracts. However, there was the possibility, albeit unlikely, that the CFTC would remove one or more contracts from its list. If the CFTC did so, such contracts would become illegal and unenforceable, because they would not be traded on a CFTC-regulated exchange.⁴⁸ This remote possibility contributed to the uncertainty among derivatives market participants.

⁴⁶ It was anticipated that trading would be authorized among investors in the U.S. by late 2001. See Joseph Weber, *Caution: Single-Stock Futures Ahead*, BUS. WK., Feb. 26, 2001, at 38. Congress passed the CFMA just hours before adjourning for the session, with no comment or debate. Prior hearings on the CFMA had not addressed many important policy issues, and the last-minute approval of the bill during the controversy surrounding the Presidential election precluded any further considerations of policy. See Frank Partnoy, *Stock Gambling on the Cheap*, N.Y. TIMES, Dec. 21, 2000, at A39. The CFMA also exempted swaps from regulation, thereby cementing some long-standing attempts by financial market participants to insulate a large portion of the derivatives market from regulation.

⁴⁷ See 7 U.S.C. § 6(a)-6(c) (2001).

⁴⁸ In the example of equity swaps, which were created to sidestep the ban of forward contracts on individual stocks and bonds, the legal uncertainty was especially great. See, e.g., Day, *supra* note 20, at E1 ("If equity swaps were deemed by a court to be futures contracts, they would become instantly illegal, on or off a regulated exchange, because of the ban on futures contracts based on individual corporate securities.").

The statutory uncertainty of OTC derivatives regulation has a complex history. During the 1980s, as derivatives were developing,⁴⁹ regulators struggled with possible responses to the differential jurisdictional treatment of derivatives.⁵⁰ In 1984, the CFTC and the SEC issued a Joint Policy Statement spelling out the types of financial derivatives the agencies believed were suitable for trading.⁵¹ Following that statement, the CFTC issued several releases addressing the issue and responded on a case-by-case basis to inquiries about regulation of particular instruments through its no-action letter process.⁵² The primary focus of the releases and responses was on the market for swaps,⁵³ which had been growing dramatically in the late 1980s. In response to a perceived need for clarification, the CFTC issued a detailed policy statement on swaps on July 21, 1989.⁵⁴

The 1989 CFTC policy statement took the position that most swap transactions were not appropriately regulated by the CFTC

⁴⁹ Even by 1989, there was \$7.1 trillion worth of outstanding notional amount of derivative financial instruments. HAMILTON ET AL., *supra* note 23, at 9. By June 1999, the estimated global notional amount was \$31.5 trillion. See *Bank for International Settlements Releases Global Derivatives Statistics*, 5 DERIVATIVES LITIG. REP., Dec. 20, 1999, at 6.

⁵⁰ Courts struggled too, which often resulted in contradictory holdings. For example, in 1984, the Seventh Circuit held that a forward contract to purchase a Government National Mortgage Associate security was properly regulated by the antifraud provisions of the securities laws, even though the forward contract itself is not a security as defined by the securities laws. See *Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582 (7th Cir. 1984).

⁵¹ See CFTC & SEC Designation Criteria for Futures Contracts and Options on Futures Contracts Involving Non-Diversified Stock Indexes of Domestic Issues, 49 Fed. Reg. 2884 (Jan. 24, 1984). Although this statement was simply a statement, not a regulation, and therefore lacked legal force, market participants observed its limits for many years when proposing new contracts. See *Bd. of Trade of Chicago v. SEC*, 187 F.3d 713, 716-17 (7th Cir. 1999).

⁵² See CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,694 n.2 (July 21, 1989) [hereinafter CFTC Policy Statement] (describing relevant proposed rules, requests for comments, and notices of proposed rule-making from 1985 through 1989); see also *id.* at 30,694 n.3 (describing several no-action letters addressing proposed offerings of derivative transactions by the CFTC Task Force on Off-Exchange Instruments).

⁵³ A swap is simply a contract pursuant to which two counterparties agree to exchange cash flows. In an interest rate swap, the counterparties exchange cash flows based on changes in some interest rate or interest rate index; in a currency swap, they exchange cash flows based on changes in some foreign exchange rate or index.

⁵⁴ See *id.* at 30,694.

and recognized "a non-exclusive safe harbor for transactions satisfying the requirements set forth herein."⁵⁵ The CFTC relied on multiple rationales for exempting swaps from regulation⁵⁶ but recognized the argument that swaps are economically equivalent to futures.⁵⁷

The CFTC policy statement listed five specific criteria relevant to determining whether the safe harbor applied. The CFTC's stated objective in issuing the policy statement was to generate "a greater degree of clarity"⁵⁸ for swap market participants. These criteria are: (1) individually tailored terms; (2) absence of exchange-style offset; (3) absence of clearing organization or margin system; (4) the transaction is undertaken in conjunction with a line of business; and (5) prohibition against marketing to the public.⁵⁹ The criteria are examined in detail below.

From 1989 until early 1993, the derivatives industry lobbied the CFTC to adopt regulations embodying the principles and objectives in the 1989 policy statement.⁶⁰ At the eleventh hour, one week before the end of her term, CFTC Chair Wendy Gramm—wife of Senator Phil Gramm—finally persuaded the CFTC to adopt the exemption (in what was described as Gramm's "farewell gift"

⁵⁵ *Id.*

⁵⁶ The CFTC stated:

Commenters have described the swap market as one in which the customary large transaction size effectively limits the market to institutional participants rather than the retail public. Market participants also have noted that swaps typically involve long-term contracts, with maturities ranging up to twelve years. In addition to these characteristics, many comparisons between swaps and futures contracts have stressed the tailored, non-standardized nature of swap terms; the necessity for particularized credit determinations in connection with each swap transaction (or series of transactions between the same counterparties); the lack of public participation in the swap markets; and the predominantly institutional and commercial nature of swap participants.

Id. at 30,695 (citations omitted).

⁵⁷ "Other commenters have stressed that despite these distinctions in the manner of trading of swaps and exchange products, the economic reality of swaps nevertheless resembles that of futures contracts." *Id.* Economically, swaps can be described as a series of forward contracts.

⁵⁸ *Id.* at 30,696.

⁵⁹ *Id.* at 30,696-97.

⁶⁰ See Matt Rees, *Swap Market: Farewell Gift from CFTC's Gramm for Swap Traders*, BLOOMBERG BUS. NEWS, Jan. 14, 1993, at 1 (on file with author).

the swaps industry⁶¹) in 17 C.F.R. § 35, known as Part 35. Part 35 is a framework for exempting particular OTC swaps from the CEA's exchange trading requirements. Part 35 exempts swaps that meet particular categories⁶² and authorizes the CFTC to grant additional exemptions on a case-by-case basis.⁶³

Part 35 did not provide nearly the certainty it could have.⁶⁴ Part 35.1(b)(1)(i)-(ii) explicitly exempted certain swap agreements, including any agreement which was

a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing) . . . [or] any combination of the foregoing.⁶⁵

In late 2000, Congress passed the CFMA, which—in addition to legalizing single-stock futures—clarified the swaps exemption. As with single-stock futures, the regulatory response was slow, and during the interim period before the CFMA derivatives markets participants were subject to regulatory uncertainty. The CFMA was passed with little substantive debate, and it is useful to reconsider the historical bases for the swaps exemption. In particular, although Congress did not explicitly consider the previously articulated 1989 CFTC policy statement, that statement offers a great deal of wisdom and perspective.

However, these particular terms were not defined, and it was unclear what tests should be applied to determine if a particular instrument fit within the list. Part 35.1(b)(2) limited eligible swap participants to: (1) financial institutions, including banks, trust

⁶¹ *Id.*

⁶² These categories include minimum financial thresholds for various institutions. *See* Exemption of Swap Agreements, 17 C.F.R. § 35.1(b)(2) (2001).

⁶³ *See id.* § 35.2.

⁶⁴ *See* Rees, *supra* note 60, at 2 (quoting a prominent derivatives attorney as saying "it's not a completely clean exemption").

⁶⁵ 17 C.F.R. § 35.1(b)(1)(i)-(ii).

companies, savings associations, credit unions, insurance companies, investment companies, commodity pools, broker-dealers, and futures commission merchants (including floor brokers or floor traders);⁶⁶ (2) large corporations, including business entities with total assets in excess of \$10 million or a net worth of \$1 million if it is entering into the swap in connection with its business or if the swap obligations are secured;⁶⁷ (3) employee benefit plans, including both certain employee benefit plans subject to the Employee Retirement Income Security Act of 1974 and certain foreign persons performing similar functions;⁶⁸ and (4) governmental entities, including the United States, states, foreign governments, multinational entities, and their political subdivisions.⁶⁹ These provisions were clear, but static, and were neither indexed to inflation nor flexible enough to allow additions or subtractions from the list based on changes over time. In the seven years after Part 35 was enacted, it did not change at all; during the same time, the derivatives industry experienced revolutionary change.

Although derivatives industry participants have relied on the safe harbor of the CFTC policy statement since 1989, and Part 35 since 1993, they do not appear to have considered in detail the application of the factors in either case. Indeed, because Part 35 was ambiguous in several respects,⁷⁰ it is useful to consider the factors in the 1989 CFTC policy statement in greater detail. For many swaps at least one of the criteria—often several—were not satisfied. Moreover, the 1989 CFTC policy statement is a very useful statement of the intended coverage of any swaps exemption. The 1989 criteria have been among the most important, yet least discussed, aspects of U.S. derivatives regulation. Legal commentators have largely ignored them. Therefore, it is worth considering these criteria in greater detail.

⁶⁶ See *id.* § 35.1(b)(2)(i)-(v), (ix), (x).

⁶⁷ See *id.* § 35.1(b)(2)(vi).

⁶⁸ See *id.* § 35.1(b)(2)(vii).

⁶⁹ See *id.* § 35.1(b)(2)(viii) (2001).

⁷⁰ For example, Part 35 does not include as exempt any swaps that are part of a "fungible class of agreements that are standardized as to their material economic terms." 17 C.F.R. § 35.2(b) (1993). This language, while ambiguous, draws heavily from all five criteria in the 1989 CFTC policy statement. See CFTC Policy Statement, *supra* note 52.

The first criterion is individually tailored terms, which relatively few swaps have. The CFTC stated, “[s]uch tailoring and counterparty credit assessment distinguish swap transactions from exchange transactions, where the contract terms are standardized and the counterparty is unknown.”⁷¹ The assumption that swaps were individually tailored may have been true in 1989; it certainly no longer holds true today. Most swap agreements are fully standardized. The International Swap Dealers Association (“ISDA”) has established a detailed standardized contract that is used for the vast majority of swap contracts. Interest rate swaps and currency swaps in particular are highly standardized. In the 1989 policy statement, the CFTC recognized that swap counterparties entering into several swap transactions might find it beneficial to enter into a “master agreement” covering all of the transactions, although it warned that it nevertheless required that “material terms of the master agreement and transaction specifications are individually tailored by the parties.”⁷² The market has moved away from the CFTC’s expressed understanding in 1989. According to the CFTC, “[t]o qualify for safe harbor treatment, swaps must be negotiated by the parties as to their material terms, based upon individualized credit determinations, and documented by the parties in an agreement or series of agreements that is not fully standardized.”⁷³ By this standard, many swaps—including many disputed swaps—would *not* qualify.

Second, in order to qualify for a safe harbor, the CFTC required that a swap not have an “exchange-style offset.”⁷⁴ This term refers to the ability of a party to liquidate a futures position by acquiring an opposite, or off-setting, position.⁷⁵ For exchange traded futures, because the counterparty to any trade is the exchange and there is a single clearing organization for any trade, there is no need to obtain the consent of the clearing organization in order to offset futures transactions. The CFTC seemed to believe in 1989 that there was a substantive difference between futures and swap transactions, because the counterparty to a swap is another party whose

⁷¹ CFTC Policy Statement, *supra* note 52, at 30,696.

⁷² *Id.* at 30,696 n.17

⁷³ *Id.* at 30,696.

⁷⁴ *Id.*

⁷⁵ *Id.*

consent was required in order to offset the swap.⁷⁶ The purpose of this requirement, as articulated by the CFTC, was to exempt only transactions that "are not readily used as trading vehicles, that are entered into with the expectation of performance and that are terminated as well as entered into based upon private negotiation."⁷⁷

This is a distinction without a difference. Parties enter into off-setting swaps quite commonly. Counterparties routinely net swaps, and it may be possible—though frequently it is very costly—to find several counterparties (other than the original counterparty to a swap) to enter into a mirror to the original swap. Legal rules, including tax and net capital requirements, explicitly recognize netting and private parties net swaps in assessing credit exposure to various counterparties. Moreover, some swaps are quite liquid and fungible and are traded using broker screens in a way that is virtually indistinguishable from exchange trades. There have been proposals to trade swaps on exchanges, and one commentator believes exchange trading is a natural solution to some of the problems posed by OTC derivatives.⁷⁸ At least one website has proposed acting as an intermediary for swap transactions.⁷⁹ Thus, since 1989, the swaps market has changed in ways that conflict with the CFTC's understanding of this second criterion.

The third safe harbor criterion is that swaps should not have a clearing organization or margin system. The CFTC clearly did not intend to exempt swaps for which there was a clearing organization or some similar system used to minimize credit risk. According to the CFTC, "this safe harbor is applicable only to swap transactions that are not supported by the credit of a clearing organization and that are not primarily or routinely supported by a market-to-market margin and variation settlement system designed to eliminate individualized credit risk."⁸⁰

As noted above, private parties act in ways (e.g., netting) that make the swaps market very similar in economic substance to the futures market. Banks mark their positions to market values at

⁷⁶ CFTC Policy Statement, *supra* note 52, at 30,696.

⁷⁷ *Id.*

⁷⁸ See STEINHERR, *supra* note 1, at xiv.

⁷⁹ See myCFO, *Homepage*, at <http://www.mycfo.com/> (last visited Oct. 26, 2001).

⁸⁰ CFTC Policy Statement, *supra* note 52, at 30,696.

least daily, and monitor certain positions more frequently. There are a few banks with large numbers of counterparties that are at least as sophisticated as the futures exchanges in reducing credit risk. There are various risk management systems available, including well known approaches such as CreditMetrics and Value-at-Risk. There even have been efforts to securitize or insure derivatives exposure to offload credit risk.⁸¹ In short, the swaps market has developed private risk management systems that resemble the credit, clearing, and margin systems of exchange markets.

Fourth, to qualify for the safe harbor, swap transactions should be undertaken in conjunction with a line of business. It is unclear how far the CFTC originally envisioned the "line of business" test would extend, but it noted that "[s]wap transactions entered into with respect to exchange rate, interest rate, or other price exposure arising from a participant's line of business or the financing of its business would be consistent with this standard."⁸²

This statement appears to draw a distinction between dealer transactions and transactions by non-dealer or non-financial parties. Transactions between banks in the OTC market—the vast majority of OTC derivatives—may be related to "line of business" exposure, although frequently they will involve speculation or arbitrage instead. But more importantly, transactions involving non-bank parties, which are more frequently disputed than bank-to-bank transactions, often will not relate to a line of business at all.⁸³

Fifth, swap transactions may not be marketed to the public.⁸⁴ This criteria merits only a short paragraph in the CFTC policy

⁸¹ For example, the London Clearing House, the clearing house for London's main derivatives exchanges, bought £150 million in credit insurance from a subsidiary of American International Group. See Sophie Belcher, *London Clearing House Buys GBP100 Million in Credit Protection*, DERIVATIVES WK., Feb. 10, 1997, at 1. This insurance protects the clearing house from credit losses of more than this amount during a three-year period. Other exchanges have purchased similar forms of default insurance.

⁸² See CFTC Policy Statement, *supra* note 52, at 30,697 n.23.

⁸³ Consider, for example, the payments Gibson Greetings was to owe on a swap transaction it entered into with Bankers Trust in October 1992: Gibson's payments would equal 5.5% minus LIBOR-squared divided by 6%. This swap, known as a "ratio swap," could not possibly have been related to any Gibson line of business. Arguably, a swap with a squared term *cannot* be related to any entity's line of business, at least on this planet. The CFTC policy statement should not cover transactions like ratio swaps, which are unrelated to a line of business.

⁸⁴ See CFTC Policy Statement, *supra* note 52, at 30,697.

statement, although that paragraph makes it clear that the CFTC assumed swaps would not be part of a bank's core sales function. This assumption also proved incorrect. Swap dealers aggressively market their transactions to clients outside the financial sector, and the greatest profits from swaps involve sales to public investors (individuals and institutions) who may lack the sophistication and information necessary to evaluate the transactions.

This movement away from the CFTC's original understanding of swaps generated great uncertainty about the regulation of OTC derivatives. Obviously, swap dealers understood the implications of this uncertainty and therefore lobbied for clearer exemptions.⁸⁵ Regulators resisted this lobbying, in part because they understood how OTC dealers lobbied previously for the 1993 exemptions in Part 35 and then expanded it to support a multi-trillion dollar unregulated industry.

For all these reasons, the legal rights of the parties to any dispute stemming from losses on OTC derivatives have been mired in uncertainty. The CTMA ameliorates some of the concerns of both industry executives and federal regulators that a counterparty might walk away from its obligations under an OTC derivatives contract and successfully argue that the contract was illegal and therefore unenforceable.⁸⁶ In late 1998, such uncertainty had generated fear among regulators that the collapse of Long-Term Capital Management, which had relied heavily on OTC derivatives contracts, would cause securities markets to unravel.⁸⁷ More recently, uncertainty has stifled innovation and contracting in the derivatives markets.

In a recent article, Michael Bennett and Michael Marin argue that some regulators use legal uncertainty and ambiguity to enhance and maintain their control over derivatives market participants.⁸⁸ Regulators in Asia often overlook or ignore questionable

⁸⁵ See sources cited *supra* note 20.

⁸⁶ See, e.g., Day, *supra* note 20, at E4 ("The legal status of OTC derivatives is murky. The enforceability of these contracts has never been tested in court. Regulators and industry executives hope it stays that way until Congress clears up the laws governing these complex, increasingly essential financial products.").

⁸⁷ See *id.*

⁸⁸ Bennett & Marin, *supra* note 13, at 9 (describing the regulatory model for such legal uncertainty as the "Casablanca Paradigm," named for the 1942 Warner Brothers movie).

market practices until political pressures force them to act.⁸⁹ This approach creates uncertainty for market participants, "because it limits the importance of regulatory precedent."⁹⁰ In Asia, regulators provide guidance to market participants on an informal basis, through the administrative approach known as *gyousei shidou*, creating burdens for firms that do not comply with the regulators and awarding benefits to firms that do.⁹¹

This informal process has benefits, especially in terms of cost. However, market participants do not have advance warning of a change in position. If the market participants have a close relationship with the regulators, it may lead to greater flexibility and perhaps greater certainty in the short term. It is difficult to obtain reliable information about derivatives losses, so it is difficult to say how such losses result in disputes.⁹²

The regulators' positions with respect to statutory coverage of derivatives are in constant flux. In derivatives markets outside the United States, there is even greater uncertainty, because market participants believe regulators might change their approach to derivatives at any time.⁹³ But even in the United States, there has not been a consistent regulatory position. For example, on November 9, 1999, the President's Working Group on Financial Markets⁹⁴ issued a report recommending additional deregulation and exemp-

⁸⁹ See CHARLES ADAMS ET AL., *INTERNATIONAL CAPITAL MARKETS* 4 (1998); Antony Currie, *Asian Derivatives: Waiting for the Big One*, *EUROMONEY*, Feb. 15 1997, at 82.

⁹⁰ Bennett & Marin, *supra* note 13, at 10.

⁹¹ See Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 *STAN. J. INT'L L.* 423 (1994); see also Bennett & Marin, *supra* note 13, at 11 n.43 (citing numerous sources).

⁹² See Robert W. McSherry, *Experts Worry Over the Potential for Derivatives Defaults by Asian Companies*, *DERIVATIVES LITIG. REP.*, Feb. 5, 1998, at 3 ("Insider reports, however, are hard to verify because of a culture of reticence that permeates the derivatives business.").

⁹³ "The fact that regulators have tolerated a practice in the past does not necessarily mean that the practice will continue to be tolerated in the future or that market participants will be given any warning before the regulators change their position." Bennett & Marin, *supra* note 13, at 10-11.

⁹⁴ The President's Working Group on Financial Markets consists of the Secretary of the Treasury, and the chairpersons of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Federal Reserve Board. See Conrad G. Bahlke, *A Brief Review of the President's Working Group Issues Report on OTC Derivatives*, *SEC. LITIG. & REG. REP.*, Dec. 22, 1999, at 10.

tions for OTC derivatives.⁹⁵ At approximately the same time, two members of Congress cosponsored a bill making equity swaps, a commonly used type of OTC derivative, subject to regulation.⁹⁶ Although the CFMA passed at the eleventh hour, it faced intense opposition.⁹⁷

Finally, the statutory uncertainty about derivatives is not limited to federal laws. Certain state laws have also generated uncertainty. In particular, there is uncertainty surrounding state laws prohibiting certain forms of gambling. There are such statutes in most U.S. states⁹⁸ and foreign jurisdictions,⁹⁹ and although there are few, if any, recent cases decided under those statutes, their language is broad enough to encompass billions of dollars of deriva-

⁹⁵ The President's Working Group Report warned that the uncertain status of some derivatives could, if not addressed, discourage innovation and growth in derivatives markets, and recommended, among other things, an exclusion from the Commodity Exchange Act for sophisticated counterparties to OTC transactions. *See id.*

⁹⁶ In early November 1999, Rep. Edward J. Markey and Sen. Byron L. Dorgan cosponsored the Derivatives Market Reform Act, which would have made equity swaps subject to regulation under the Securities Exchange Act. *Id.*

⁹⁷ *See Senate Bill 2697, supra* note 41, at 9.

⁹⁸ For example, under New York law, a transaction is illegal gambling if it is a "wager[], bet[] or stake[] made to depend upon any . . . chance, casualty or unknown or contingent event whatever . . ." N.Y. GEN. OBLIG. LAW § 5-401 (McKinney 1989). Similarly, New York's criminal statute states that "[a] person engages in gambling when he stakes or risks something of value upon . . . a future contingent event not under his control or influence, upon an agreement or understanding that he will receive something of value in the event of a certain outcome." N.Y. PENAL LAW § 225.00 (McKinney 1989).

⁹⁹ For example, most Asian countries have anti-gambling statutes. In Asia, a cash settled transaction (as opposed to a physically settled transaction) is more likely to be deemed an illegal gambling contract. *See Bennett & Marin, supra* note 13, at 41. For example, courts in Taiwan have found that cash settled derivatives transactions constitute gambling. *Id.* (basing such a conclusion on advice received from the Taipei law firm of Lee and Li). Under the Philippine Civil Code, cash-settled OTC equity options and forward contracts are likely to be held null and void as illegal gaming contracts. *Id.* (basing such a conclusion on advice received from the Manila law firm of SyCip, Salazar, Hernandez & Gatmaitan). In a cash settled transaction, the underlying asset never changes hands; the parties simply exchange cash at the end of the contract. For example, if a party contracts to buy gold on a forward basis, at the expiration of a physically settled contract, she would pay cash and receive the gold; at the expiration of a cash settled contract, she would pay or receive the difference between the value of the gold and the value of the cash. *See ZVI BODIE & ROBERT C. MERTON, FINANCE* 366-68 (2000). Cash settled transactions are less costly and more convenient, especially for parties who do not actually require delivery of physical assets.

tives transactions.¹⁰⁰ Not surprisingly, derivatives purchasers have seized on this broad language claiming that the applicable transactions were illegal under the anti-gambling laws of various jurisdictions.¹⁰¹ To the extent particular OTC derivatives are not covered by the swaps exemption, this argument is a serious one.

Several legal scholars have argued that many financial derivatives can be considered as gambling, and the line between legitimate transactions and gambling is less than clear.¹⁰² New rules promulgated by the Financial Accounting Standards Board attempt to draw the line between hedging and speculation in the derivatives context, with results that are both complex and often counterintuitive.¹⁰³ Many recently issued securities easily could be categorized as illegal gambling contracts including, for example: a bond linked to the number of victories by the Utah Jazz, a professional basketball team;¹⁰⁴ a derivative security based on an interest rate index multiplied by itself three times;¹⁰⁵ or so-called Asian op-

¹⁰⁰ Many such statutes are both vague and broad, especially outside the United States. For example, the Indonesian Civil Code provides simply that all claims arising from games or betting are unenforceable; Hong Kong's Gambling Ordinance prohibits gaming, betting, and bookmaking and defines gaming as the playing of any game for winnings in money or other property. See Bennett & Marin, *supra* note 13, at 39-40 n.166; see also Gillian Tett, *Traders Gamble on an Anomaly*, FIN. TIMES (London), July 17, 1998, at 6 (discussing applicability of Japanese anti-gambling laws to financial derivatives).

¹⁰¹ See, e.g., *Korea Life Files 2nd Amended Complaint Against Morgan Guaranty*, 6 DERIVATIVES LITIG. REP., July 3, 2000, at 3 (noting claims raised under New York gambling statute).

¹⁰² See, e.g., Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling? - Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987 (1992); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701 (1999). Legislators also have made this point. See STEINHERR, *supra* note 1, at 151 (citing Rep. Henry Gonzalez as saying, "You can call it [the use of derivatives] whatever you want, but in my book it's gambling.").

¹⁰³ FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT OF FINANCIAL CONCEPTS NO. 113; see also Michael S. Lesak, Comment, *FASB's Folly: A Look at the Misguided New Rules on Derivatives Valuation and Disclosure*, 29 LOY. U. CHI. L.J. 649 (1998).

¹⁰⁴ See JOHN EATWELL & LANCE TAYLOR, *GLOBAL FINANCE AT RISK: THE CASE FOR INTERNATIONAL REGULATION* 101 (2000). I am grateful to Peter H. Huang for pointing out this example.

¹⁰⁵ See FRANK PARTNOY, F.I.A.S.C.O.: THE INSIDE STORY OF A WALL STREET TRADER 139-40 (1999).

tions, whose payoff can depend on a continuously sampled geometric average.¹⁰⁶

Several states also have so-called "bucket shop" laws,¹⁰⁷ which present a similar problem to those posed by the anti-gambling statutes. Bucket shop laws prohibit wagering on changes in the market prices of securities by means of "fictitious transactions in such securities."¹⁰⁸ One court has held that an interest rate swap was not subject to California's bucket shop law.¹⁰⁹ However, it is questionable whether the analysis in that case would prevent most derivatives from falling under the law.¹¹⁰

In sum, statutes regulating derivatives are all over the financial map. They provide little clarity or certainty to market participants who have attempted to opt out of these statutes by structuring transactions outside their reach. For some parties involved in derivatives disputes, it is unclear if the statutes apply at all.

3.2. *Judicial Treatment of Derivatives Disputes*

The above discussion of the statutory coverage of derivatives shows how difficult it can be to determine whether a particular derivative is a regulated security, a regulated commodity, or is un-

¹⁰⁶ See WILMOTT, *supra* note 9, at 215-26.

¹⁰⁷ See, e.g., CAL. CORP. CODE §§ 29000-29201 (West 1977 & Supp. 2001).

¹⁰⁸ *In re Thrifty Oil Co.*, 212 B.R. 147, 153 (Bankr. S.D. Cal. 1997) (citing California statutes).

¹⁰⁹ *Id.* at 154.

¹¹⁰ First, that court noted that the interest rate swap did not involve a security or commodity, as California's law requires. See CAL. CORP. CODE § 29004 (West 1977) (defining security as "all shares in any corporation or association . . . and other evidences of debt or property and options for the purchase or sale thereof or any rights entitling the holder thereof to participate in profits or a division of assets"); *id.* § 29005 (West 1977) (defining commodity as "anything movable that is bought and sold"). Even if it were the case that the payments on a fixed-for-floating interest rate swap did not involve a security or commodity according to the statutory definition, many other derivatives would involve a security or commodity. Second, the court noted that the bucket shop statute only covers agreements where neither party intends to deliver the security or commodity. See *id.* § 29008 (West 1977). The court apparently misunderstood the meaning of this section of the statute as requiring that one or both of the parties not intend to fulfill its part of the contract: "[The parties] fully intended to perform their payment obligations under the swaps--there was no fictitious transaction." *In re Thrifty Oil Co.*, 212 B.R. at 154.

regulated.¹¹¹ This determination is crucial in a dispute about losses stemming from an investment in derivatives. If a judge determines that the derivatives subject to dispute were securities or commodities, then a federal regulatory regime would apply to the resolution of the dispute;¹¹² if not, the judge would dismiss the federal claims and any state law claims would remain.

In some cases, judges and regulators have strained to argue that particular OTC derivatives were governed by securities or commodities laws.¹¹³ However, in most of the relevant cases, as the parties intended, the derivatives are governed by neither, and the judges are left to resolve state law claims predominantly under common law.¹¹⁴ The problem presented here thus relates to the resolution of disputes when there is no applicable federal statutory law. In these cases, the parties are seeking to resolve disputes based on common law and analogical reasoning. Derivatives complaints in such cases have alleged breach of fiduciary duty, common law fraud and negligent misrepresentation, lack of authority, and various contract-based claims.¹¹⁵

¹¹¹ For example, a court would resolve a dispute concerning an investment in a "security." See *supra* note 26 which defines "security" as used in the 1933 and 1934 Acts, under the applicable federal securities laws (most likely under Rule 10b-5), regardless of whether the economic qualities of the instrument make it a "derivative." Similarly, a court would resolve a dispute concerning a commodity under the relevant federal law. Such disputes involving "regulated" derivatives do not present the same serious difficulties posed in disputes involving OTC derivatives.

¹¹² In disputes about derivative *securities* or *commodities*, a court will rule that a particular statute applies and then the parties will go about litigating under the terms of that statute. The parties may be uncertain whether the statutory regime applies to their contract. This problem is addressed in Section 4.2.1 and is not of additional concern for purposes of this Section.

¹¹³ See, e.g., *In re* BT Secs. Corp., Exchange Act Release No. 35,136, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477, at 86,114 (Dec. 22, 1994) (assuming that Bankers Trust violated the securities and commodities laws without finding explicitly that the interest rate swaps Bankers Trust sold were securities or commodities).

¹¹⁴ These claims also may include state statute-based claims. See *supra* notes 98-106 and accompanying text (describing anti-gambling statutes in New York and Asia and relevant derivatives). For a description of some of the common law arguments by practitioners in derivatives cases through 1997, see Aaron Rubinstein, *Derivatives and Risk Management: Common Law Theories of Liability in Derivatives Litigation*, 66 *FORDHAM L. REV.* 737 (1997).

¹¹⁵ See, e.g., Joanne Medero et al., *Investing in Derivatives: Current Litigation Issues*, 8 *INSIGHTS* 4 (Nov. 1994) (noting that complaints include "claims for common law fraud, negligence, negligent misrepresentation, and breach of fiduciary duty")

In this Section, I analyze how courts in some representative cases have treated these various state common law claims. The drawbacks of common law in this area are enormous. It is extraordinarily expensive to resolve these disputes, and there are few published decisions to guide future parties. Facts are difficult to ascertain. Complaints often do not describe the underlying transactions accurately¹¹⁶ and neither do the paltry number of judicial opinions. Jurisdictional battles are fierce and costly.¹¹⁷ Documents

as well as claims under section 10(b) of the Securities Exchange Act, sections 11 and 12(2) of the Securities Act, and various sections of the Investment Company Act). Another potential ground for recovery is commercial frustration or impracticability, based on unanticipated changes in one or more of the instrument or indices underlying a particular derivatives contract. See, e.g., *Aluminum Co. of Am. v. Essex Group, Inc.*, 499 F. Supp. 53, 70-78 (W.D. Pa. 1980) (stating that the purpose of contract based on wholesale price index was commercially frustrated by unexpected increases in the price of oil).

¹¹⁶ The parties and their lawyers may not completely understand the transactions. See, e.g., STEINHERR, *supra* note 1, at 78 ("OTC products can be complex enough to raise questions about how well understood they are even by experienced corporate treasurers. There is an associated uncertainty about the value of complex products for which there is no market.").

¹¹⁷ For example, Judge Feikens held in *Procter & Gamble v. Bankers Trust* that because the parties agreed to be bound by New York statutes and case law, there was no claim under Ohio statutes and therefore dismissed such claims. See *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1289 (S.D. Ohio 1996). This ruling was not particularly controversial, although it shows that federal judges are willing to defer to private choice of law provisions, even when one party may have violated the law of that court's jurisdiction. Note that this deference would be critical to the survival of a synthetic common law regime. Although federal courts would retain limited judicial review of synthetic common law dispute resolution, courts would need to show deference to private parties' choice of regime, even if one party acted contrary to federal or state law.

Several derivatives cases have presented difficult jurisdictional issues. When *Societe Nationale d'Exploitation Industrielle des Tabacs* ("SEITA"), the French national tobacco company, filed suit against *Salomon Brothers International Limited*, the London arm of a U.S. investment bank, in the Southern District of New York, Judge Sweet dismissed the claim for lack of subject matter jurisdiction, because the alleged fraudulent representations were made in London and "[a]s a French corporation headquartered in Paris, SEITA relied on the alleged misrepresentations, executed the Swaps, and realized its losses in Paris." *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Bros. Int'l Ltd.*, 928 F. Supp. 398, 403 (S.D.N.Y. 1996). SEITA subsequently sued in New York Supreme Court. I served as a consultant to SEITA during a portion of the litigation. In a more recent case, *Merrill Lynch International* moved to dismiss a complaint by *Slovnaft A.S.*, the former Slovak national oil company, on grounds of *forum non conveniens*, claiming the parties had no New York interests and had agreed to resolve any disputes in English courts. See *Merrill Lynch Seeks Dismissal of \$75 Million Slovnaft Derivatives Suit*, 5 BANK & LENDER LIAB. LITIG. REP., Jan. 19, 2000, at 10.

are not available, or are under seal. Many important pieces of evidence are destroyed or are otherwise unavailable by the time discovery begins.¹¹⁸ The result is an expensive, inefficient, unfair, and uncertain process.

If Oliver Wendell Holmes were alive today, he surely would want to decide—or at least to write about—disputes involving the multi-trillion dollar market for OTC financial derivatives.¹¹⁹ Holmes was interested in the major conflicts of his day, in the influences of technology and scientific progress, and—as he often is quoted—in experience over logic.¹²⁰ To a judge such as Holmes, the temptations of derivatives disputes would be overwhelming:

When PT Dharmala Sakti Sejahtera, an Indonesian financial services company, sued Bankers Trust, arguing it was not obligated to pay for losses on a complex derivative because it had not fully understood the transaction, an Indonesian court ruled in favor of Dharmala, but the case was transferred to a British court, which ruled that Dharmala was capable of understanding the risks involved in the transaction. *See Bankers Trust Int'l PLC v. PT Dharmala Sakti Sejahtera*, (unreported Q.B. (Comm. Ct.) 1 Dec. 1995). The parties later settled the dispute. Chase Manhattan Bank recently moved to dismiss on the basis of *forum non conveniens* two complaints filed in the Southern District of New York by two Liberian companies acting on behalf of Greek individuals, arguing that New York was an inconvenient forum because witnesses and documents are in Europe, and that the parties chose English law to govern their investments. *See Briefs Submitted on Motion to Dismiss Suit Against Chase Manhattan*, 6 DERIVATIVES LITIG. REP., July 3, 2000, at 5, 7. The suit and motion obviously were motivated by the availability in the U.S. of punitive damages and liberal discovery.

¹¹⁸ For example, tape recordings of incriminating conversations were of critical importance in the litigation against Bankers Trust. *See BT Secs. Corp.*, *supra* note 113, at 86,114; *see also* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 627-28 (1996) (quoting a recorded comment by a BT Securities employee). However, banks have learned from Bankers Trust's mistakes and now either do not record conversations or set up systems to erase or destroy the tapes within a relatively short period of time as a routine business practice. In one recent case, the plaintiffs requested additional depositions because the defendant bank allegedly had erased tape recordings related to the relevant swap transactions. *See Seita Claims SBIL Destroyed Tapes; 'Nonsense,' Salomon Says*, DERIVATIVES LITIG. REP., May 7, 1998, at 9.

¹¹⁹ Financial derivatives are financial instruments whose value is based on, or derived from, some other underlying instrument or index. *See Partnoy, Regulatory Arbitrage*, *supra* note 1, at 216-26 (describing classes and uses of derivatives). As of year-end 1999, the size of the derivatives market was estimated at more than \$100 trillion. *See Seita Claims*, *supra* note 118. Over-the-counter financial derivatives are those not traded on any exchange.

¹²⁰ OLIVER WENDELL HOLMES, *THE COMMON LAW* 1 (Little, Brown, and Co. 1909) (1881).

hard-fought, novel claims involving leaders of industry and billions of dollars; breathtaking innovation and complexity underlying the relationships of the parties; and, above all, the kind of logic-defying real-world experience that Holmes believed defined the substance of the law.¹²¹ Most importantly, the jurisprudence of derivatives disputes is a *tabula rasa* available for a bold, intelligent jurist to make his or her mark.

Unfortunately, the judges thus far presented with OTC derivatives claims have, to put it charitably, not been of Holmes's stature. Judges have shied from deciding any core issues in these cases, either because they fear the effects of an off-the-mark precedent or because they are overwhelmed by the detail and complexity of the cases. Although the OTC derivatives market is among the largest markets in the world and is chock full of disputes, judges only rarely have decided even narrow issues in derivatives disputes, and they almost never write detailed opinions.¹²² The vast majority of cases settle before trial in most areas of law, but the derivatives area is striking for the near total absence of judicial opinions and decided cases on important issues. Only one derivatives claim ever has been tried,¹²³ and that trial was a decade ago, well before the recent waves of derivatives disputes. Only a handful of disputes have led to judicial opinions on dispositive motions.

The trepidation of a judge facing a derivatives dispute is understandable. The financial instruments underlying the disputes are complex, and the relationships among parties and transactions are difficult to understand.¹²⁴ Some judges might find unraveling

¹²¹ Holmes's attempt to present "a general view of the Common Law" recognized the importance of both history and current practice: "The substance of the law at any given time pretty nearly corresponds, so far as it goes, with what is then understood to be convenient; but its form and machinery, and the degree to which it is able to work out desired results, depend very much upon its past." *Id.* at 1-2.

¹²² A rare exception is the opinion by Judge Feikens in *Procter & Gamble*, 925 F. Supp. at 1270, which considered multiple claims in detail. Ironically, Judge Feikens, in Ohio, was interpreting New York state law, and the New York state courts subsequently have rejected a portion of his opinion with little analytical support or explanation. See *infra* notes 141-144 and accompanying text.

¹²³ To my knowledge, the only trial in a derivatives case was the one reviewed in *BankAtlantic v. Blythe Eastman Paine Webber, Inc.*, 955 F.2d 1467 (11th Cir. 1992). See discussion *infra* notes 233-236 and accompanying text.

¹²⁴ Because parties often use special purpose vehicles, subsidiaries, off-shore partnerships, and corporations, and other intermediaries, it often is difficult to

such a case to be impossible. Moreover, any decision would probably have vast repercussions, potentially affecting trillions of dollars of transactions. No judge wants to be accused of bringing down a market, especially in New York where many derivatives disputes are filed.

3.2.1. *Breach of Fiduciary Duty*

One of the core common law claims in financial disputes has been breach of fiduciary duty.¹²⁵ However, the derivatives cases on fiduciary duty have been so conflicted, muddled, and restrictive that many plaintiffs are now choosing not to include fiduciary duty claims in their complaints. This is due in large part to an effort to avoid the cost associated with resolving complex motions to dismiss and for the strategic reason of avoiding early partial dismissal, which now seems likely given recent case law.

Fiduciaries and fiduciary concepts have a long history in the law, beginning with Roman law.¹²⁶ Yet there is no clear definition of a fiduciary or a fiduciary relationship. As Justice Frankfurter

discern the true counterparties to a particular transaction, a fact some derivatives sellers have attempted to use to distance themselves from purchasers.

¹²⁵ In contrast to the stock markets, where most breach of fiduciary duty claims arise in the context of shareholder suits against managers and directors, most of the breach of fiduciary claims in the derivatives context have been by one party to a derivatives contract alleging a breach of fiduciary duty by the other, not by shareholders alleging breach of fiduciary duties by managers. There are some shareholder against management cases, however. For example, in the litigation related to Orange County's losses on derivatives, shareholders of Merrill Lynch & Co. sued the company's directors in New York state court for breach of fiduciary duty to Merrill and its shareholders. However, the suit was dismissed in part because shareholders failed to support their assertion that a pre-suit demand on the board would have been futile. See *Wilson v. Tully*, 676 N.Y.S.2d 531 (N.Y. App. Div. 1998); *Shareholder Suit Against Merrill Lynch Dismissed for Failure to Make Pre-Suit Demand*, PROF. LIAB. LITIG. REP., Aug. 1999, at 10. For a discussion of such suits based on hedging decisions by managers, see Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani-Miller Forty Years Later*, 1998 U. ILL. L. REV. 1039, 1102-04 (1998); see also George Crawford, *A Fiduciary Duty to Use Derivatives?*, 1 STAN. J.L. BUS. & FIN. 307, 329-30 (1995) (discussing a hypothetical suit that imposed a duty on the trustee to use derivatives as a hedge).

¹²⁶ The term fiduciary is derived from Roman law. In general, a fiduciary was a person holding the character of a trustee. For example, a fiduciary heir (*fiduciarius heres*) was the person who was instituted heir and who was charged to deliver the succession to a person designated by the testament. A *fiducia* was an early form of mortgage under Roman law. See BLACK'S LAW DICTIONARY 563-64 (5th ed. 1979).

famously put it, "[t]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?"¹²⁷ These inquiries rarely lead to clear answers.

In recent years, fiduciary notions have become hopelessly muddled in many areas of law. The term fiduciary is infused with the concept of trust; a fiduciary holds something in trust for another. But the term also includes notions of power and duty; a fiduciary relationship is created when one person is given power and the duty to use that power to help another person.¹²⁸ The term fiduciary is an objective notion; a person either is a fiduciary or is not, and fiduciary duties may be triggered or halted¹²⁹ based on certain objective standards of conduct or behavior.¹³⁰

For example, much of corporate law is fiduciary duty law. Corporate law says that directors and officers of corporations—and sometimes shareholders—are in a fiduciary relationship with their corporation and its shareholders. Many corporate law scholars view fiduciary duty simply as a gap filler. As two leading corporate law scholars have noted, "[c]orporate law—and in particular the fiduciary principle enforced by courts—fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance."¹³¹

¹²⁷ SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

¹²⁸ J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* 97 (1981).

¹²⁹ There is no fixed scale for measuring fiduciary duty, although the courts have balanced allowing fiduciaries to act or transact with protecting shareholders. See ARTHUR R. PINTO & DOUGLAS M. BRANSON, *UNDERSTANDING CORPORATE LAW* 182 (1999); see also *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1961) (indicating that fiduciary duties are subject to "no fixed scale").

¹³⁰ Interestingly, the term fiduciary also refers to the "system of marking in the reticule of an optical instrument used as a reference point or a measuring scale." WEBSTER'S II NEW RIVERSIDE DICTIONARY 475 (1984).

¹³¹ Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-45 (1989). The hypothetical bargain approach of corporate law assumes that managers and shareholders have asymmetric information. Fiduciary duty default rules thus are intended to ameliorate asymmetric information that actually persists. It is necessary to impose duties on management, because it is the rule that shareholders and managers would have agreed to absent transaction costs, i.e., it is the rule necessary to resolve the information asymmetry between shareholders and management. If management has superior information, the argument goes, fiduciary duty rules are necessary to prevent management from using such information to exploit shareholders.

With this uncertainty about fiduciary duty as a backdrop, parties began adding breach of fiduciary duty claims to their derivatives complaints. The results of combining fiduciary duty claims with the facts of complex derivatives have been abysmal, as one might expect, given the complexity surrounding each notion independently.

The first judge to consider in detail a breach of fiduciary duty claim by a derivatives purchaser against a seller was Judge John Feikens of the Southern District of Ohio in the suit brought by P&G against Bankers Trust ("BT") in 1994.¹³² Although most scholars have focused on the federal securities and commodities claims in P&G's complaint, the complaint also included a variety of state common law claims—fraud, misrepresentation, breach of fiduciary duty, negligence, and negligent misrepresentation—in addition to numerous federal statutory claims.¹³³ These claims are of great interest and relevance here.¹³⁴

P&G alleged that BT had not adequately explained the risks inherent in swap transactions P&G entered into with the bank. In each case, the swap payments were based on complex formulas and consisted, in economic terms, of a portfolio of forward and option contracts. As a result of leverage, the bets embedded in the swap contracts were very large, approaching the size of the entire issue of a U.S. government bond of comparable maturity. Moreover, the swap contracts were designed in a way that masked the size of the exposure on the contract, although the terms of the contract clearly specified its payouts and a sophisticated party would

¹³² *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996). Judge Feikens's opinion remains one of the most thorough and well-reasoned judicial considerations of any derivatives claim to date, although many regard as *dicta* the discussion in that case of state common law claims.

¹³³ The federal statutory claims included alleged violations of section 17 of the Securities Act of 1933, sections 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, sections 4b and 4c of the Commodity Exchange Act, and section 32.9 of the Rules of the Commodity Futures Trading Commission. *See id.* at 1274. P&G also included claims based on Ohio state law, including violation of Ohio Blue Sky Laws and the Ohio Deceptive Trade Practices Act. *See id.* Gibson Greetings, Inc., a manufacturer of greeting cards, filed a suit alleging similar state common law claims against Bankers Trust on September 12, 1994. *See Gibson Greetings, Inc. v. Bankers Trust Co.*, No. C-1-94-620 (S.D. Ohio filed Sept. 12, 1994).

¹³⁴ At the time, there already existed a body of statutory law and common law cases for use in resolving the federal claims. However, the state common law claims were novel in the derivatives context and to some extent still are.

have been able to analyze the swap's exposure. In addition, there were recordings of BT salespeople discussing misrepresentations related to such swap valuations. The suit was settled well before trial, with P&G agreeing to pay \$35 million of the roughly \$200 million it owed.¹³⁵

P&G contended that a fiduciary relationship existed between it and BT. Judge Feikens granted BT's motion for summary judgment as to P&G's claim of breach of fiduciary duty but noted that "[t]his does not mean, however, that there are *no* duties and obligations in their swaps transactions."¹³⁶ It is difficult to interpret this sweeping statement. How are market participants to know if the seller bank owes a fiduciary duty of any kind or scope? Did P&G's size or sophistication matter to this determination? Was the nature of the relationship between P&G and BT a factor? Was the swap's structure relevant? Was the fact that a swap was individually tailored to a particular counterparty evidence that the purchaser was receiving some special treatment? Although this Ohio decision did not bind other courts outside of Ohio deciding breach of fiduciary duty claims under New York law, it did create uncertainty for future cases.

In a more recent similar case, involving a more complex product sold to a less sophisticated purchaser, a New York state court also rejected a breach of fiduciary duty claim. In 1994 and 1995, Societe Nationale D'Exploitation Industrielle Des Tabacs ("SEITA"), the French national tobacco company, lost \$29 million on two swap transactions it entered into with Salomon Brothers International Limited ("SBIL").¹³⁷ According to the allegations, a SBIL salesman in London, Gilles Albou, acted fraudulently and concealed certain risks in order to convince former SEITA treasurer, Marc Tardieu, that he could make millions of dollars for his company by investing in two swaps.¹³⁸

¹³⁵ Gibson agreed to pay \$6.18 million of the roughly \$20 million it owed to BT. See Bennett & Marin, *supra* note 13, at 3 n.11 (describing resolution of Procter & Gamble and Gibson Greetings cases).

¹³⁶ *Procter & Gamble*, 925 F. Supp. at 1289.

¹³⁷ See SD NY Denies French Firm Federal Jurisdiction for Suit over U.S. Swaps, DERIVATIVES LITIG. REP., July 8, 1996, at 3.

¹³⁸ One swap was tied to the German mark; the other was tied to the Japanese yen. See *id.*

Thus, the facts resembled those of the earlier P&G case. SBIL, like BT, ran a sophisticated derivatives trading operation, while SEITA, like P&G, obviously was less sophisticated. SEITA had far less experience with derivatives than P&G, which had been trading billions of dollars of derivative instruments for several years.¹³⁹ The derivative SEITA purchased was a complex swap that SBIL had designed in a way that masked both its size and risk and that a sophisticated buyer might have understood fully, but that SEITA likely did not. The instrument SEITA purchased involved a portfolio of digital (or binary) options¹⁴⁰ and therefore was more difficult to evaluate than P&G's swap with BT. New York law applied in both cases, although SEITA's suit was in state court in New York, not in Ohio.¹⁴¹

In deciding SBIL's motion for summary judgment, Judge Charles Edward Ramos found that SEITA was a sophisticated counterparty to the swap and granted summary judgment to SBIL on the fiduciary duty claim.¹⁴² Unfortunately, Judge Ramos did not clarify the coverage of the P&G case, except to note in passing that a large French tobacco company is a sophisticated party and was aware of the risks involved; BT had made similar arguments in the prior case.¹⁴³

At best, Judge Ramos's five-paragraph discussion of fiduciary duty in his opinion is of little or no value to other participants in the derivatives industry. It fails to articulate any general principles of law, to analyze existing precedents in other areas, to explain which facts were important to the decision, or even to set forth the nature of the transaction in any comprehensible detail.

At worst, Judge Ramos's cursory dismissal of the claim is very costly. Judge Ramos's opinion has generated great uncertainty

¹³⁹ See Partnoy, F.I.A.S.C.O., *supra* note 105, at 94.

¹⁴⁰ Digital options pay either a fixed sum or zero (i.e., have a discontinuous payoff) depending on some contingency. See WILMOTT, *supra* note 9, at 34-35.

¹⁴¹ SEITA had sued first in federal court in New York, but that suit was dismissed on jurisdictional grounds. See *SD NY Denies*, *supra* note 137. SEITA's state court suit also included other common law claims, including fraud. *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Bros. Int'l Ltd.*, No. 113154/96, 1998 N.Y. Misc. LEXIS 219 (N.Y. Sup. Ct. Feb. 9, 1998).

¹⁴² See *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes*, 1998 N.Y. Misc. LEXIS 219, at *3. Ultimately, the judge dismissed SEITA's other claims as well.

¹⁴³ See *id.* at *6.

among participants in the derivatives industry, who cannot understand from the opinion when, if ever, a counterparty to a derivative contract would be able to survive a summary judgment motion. The New York Appellate Division, First Department, did not help matters by affirming the decision with little additional guidance.¹⁴⁴ The decisions' naked rejection of fiduciary duty claims seem to have scared plaintiffs from including such claims in their complaints, a result that even contractarian legal scholars should find difficult to justify based on the historical treatment of fiduciary duty claims as gap-fillers in at least some circumstances.

Recent federal cases addressing these state law issues also provide little guidance.¹⁴⁵ The law in the Second Circuit, the leading court for business disputes, regarding fiduciary duties owed by brokers to clients is hopelessly muddled.¹⁴⁶ For example, in *Inde-*

¹⁴⁴ See *Societe Nationale D'Exploitation Industrielle Des Tabacs et Allumettes v. Salomon Bros. Int'l Ltd.*, M-1208, 2000 N.Y. App. Div. LEXIS 5004 (N.Y. App. Div. Apr. 27, 2000) (denying without opinion leave to appeal to the New York Court of Appeals). The First Department of the New York Appellate Division previously noted that it did not subscribe to the articulation of New York law in the P&G case, although it left open the possibility of finding something more than a "business relationship" in future cases, thereby creating additional uncertainty. See *Societe Nationale D'Exploitation Industrielle Des Tabacs et Allumettes v. Salomon Bros. Int'l Ltd.*, 674 N.Y.S.2d 648, 649 (N.Y. App. Div. 1998).

¹⁴⁵ A few cases have attempted to resolve these issues under federal statutory law. See, e.g., *Banca Cremi, S.A. v. Alex Brown & Sons, Inc.*, 132 F.3d 1017 (4th Cir. 1997) (evaluating claim related to investment in mortgage derivatives under federal law).

¹⁴⁶ To complicate the analysis further, there also are other, sometimes contradictory, lines of cases on fiduciary duty in New York. One line holds that absent a showing of "special circumstances" that could have transformed a business relationship into a fiduciary relationship, a court will dismiss a claim for fiduciary duty; such "special circumstances" can include "control by one party of the other [or] creation of an agency relationship." *L. Magarian & Co. v. Timberland Co.*, 665 N.Y.S.2d 413, 414 (N.Y. App. Div. 1997) (citing cases for both sets of "special circumstances" and, finding neither, dismissing the complaint). Another line holds that generally the legal relationship between customer and bank is arm's length, but that a fiduciary relationship may arise when the bank "assumes control and responsibility over the customer's assets," or when "the customer places special trust and confidence in the bank and thereby becomes dependent upon it." *ADT Operations, Inc. v. Chase Manhattan Bank*, 662 N.Y.S.2d 190, 192-93 (N.Y. Sup. Ct. 1997). There are separate, but related, cases involving insurance companies. See, e.g., *Goshen v. Mutual Life Ins. Co. of N.Y.*, No. 95-006, 1997 N.Y. Misc. LEXIS 486, at *33-34 (N.Y. Sup. Ct. Oct. 24, 1997) (citing both "special trust and confidence" and "dependence" prongs of the banking fiduciary duty test).

pendent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.,¹⁴⁷ the Second Circuit upheld the dismissal of a complaint, noting that where there were insufficient allegations to support a finding of any broader duties, a broker owes a client only limited duties with respect to a non-discretionary account.¹⁴⁸ However, in interpreting *Independent Order of Foresters* and a similar, later Second Circuit case,¹⁴⁹ Judge Koeltl, in *Kwiatkowski v. Bear Stearns* ("*Kwiatkowski II*"),¹⁵⁰ held that it remains clear that the

relationship between a broker and its client is fiduciary in nature and that duties broader than those related to the execution of a transaction may arise as a result of the particular relationship between the broker and the client and the scope of the matters with which the broker is entrusted.¹⁵¹

The catch phrase noting the existence of a fiduciary duty, but limiting its scope to "matters relevant to affairs entrusted to the broker," appears in numerous recent cases in the Second Circuit.¹⁵²

The results in the cases are difficult to reconcile. Consider, for example, the differences between the allegations in *Press v. Chemical Investment Services Corp.*¹⁵³ and *Independent Order of Foresters* on one hand, and *Kwiatkowski II* on the other. In *Press*, the broker

¹⁴⁷ *Indep. Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933 (2d Cir. 1998). This case involved the appeal of the dismissal of breach of fiduciary duty claims by a fraternal society that issued insurance policies and annuities to its members and had invested in certain derivatives. *Id.*

¹⁴⁸ These duties include, for example, a duty to notify a customer before making trades where authorization is required and a duty to execute requested trades. *See id.* at 941.

¹⁴⁹ *See Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999) (quoting *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045, 1055 (S.D.N.Y. 1988)) (attempting to reconcile the notion that the broker owes no fiduciary duty to the client with the notion that a broker's fiduciary duty to a client is "limited to 'matters relevant to affairs entrusted to the broker'").

¹⁵⁰ *Kwiatkowski v. Bear, Stearns & Co.*, No. 96 Civ. 4798, 1999 U.S. Dist. LEXIS 19966 (S.D.N.Y. Dec. 29, 1999) [hereinafter *Kwiatkowski II*].

¹⁵¹ *Id.* at *29.

¹⁵² *See Press*, 166 F.3d at 536; *Rush*, 681 F. Supp. at 1055; *Kwiatkowski II*, 1999 U.S. District LEXIS 19966, at *31.

¹⁵³ *See Press*, 166 F.3d at 529.

failed to disclose a substantial markup on the sale of a treasury bill. In *Independent Order of Foresters*, the broker failed to explain the risks associated with several complex transactions to a "fraternal society." In *Kwiatkowski II*, the broker liquidated the client's positions in a downward-moving market in order to avoid unsecured losses. In the first two cases, the fiduciary duty claim was dismissed; in the third, it was upheld.

Is it possible to say that secretly adding a substantial markup to a virtually risk-free transaction or failing to advise a less sophisticated party about a complex instrument is not a "matter relevant to affairs entrusted to the broker," but that liquidating a client's positions in a volatile market is?¹⁵⁴ The rationale for fiduciary duty traditionally has been based on the information or sophistication gap between the parties. It is difficult to understand how this gap varied in the three cases, and the courts do not attempt to address the difficulty. There certainly is no explanation, for example, of how the plaintiff in *Kwiatkowski II*, but not in the other cases, could or would have bargained for fiduciary protection absent transaction costs.

It is worth setting forth in greater detail some of the facts and analysis in *Kwiatkowski II* to demonstrate how difficult it is for a judge to resolve a fiduciary duty claim in a complex financial dispute.¹⁵⁵ Before 1990, when he opened a foreign currency trading account at Bear, Stearns, Henryk de Kwiatkowski, a wealthy individual investor,¹⁵⁶ had "engaged in hundreds of millions of dollars of foreign currency transactions through his bank in the Bahamas, Bank Leu."¹⁵⁷ Bear, Stearns made standard form disclosures in which Kwiatkowski acknowledged the risk of trading in foreign

¹⁵⁴ *Press*, 166 F.3d at 536 (quoting *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045 (S.D.N.Y. 1988)).

¹⁵⁵ Moreover, *Kwiatkowski II* is one of the few cases from which parties can glean the relevant facts. In other cases, facts are missing either because the judge decided to omit them (or could not understand and articulate them) or because the facts were under seal or subject to a confidentiality order. See, e.g., *SEITA*, *supra* note 137 (limited recitation of facts does not even include a description of the transaction). A jury awarded Kwiatkowski \$164 million, and an appeal was pending in late 2001. See *Bear Stearns Says Investor's Brief Lacks "Critical Ingredient,"* 7 DERIVATIVES LITIG. REP., Aug. 13, 2001, at 3.

¹⁵⁶ In 1991, Kwiatkowski had a net worth of \$100 million. See *Kwiatkowski II*, 1999 U.S. Dist. LEXIS 19966, at *7.

¹⁵⁷ *Id.* at *6.

currency futures, and Kwiatkowski then began trading billions of dollars worth of currency futures on the Chicago Mercantile Exchange ("CME").¹⁵⁸ As Kwiatkowski's positions increased during late 1994, they became too large for the CME,¹⁵⁹ and on December 6 and 7, 1994, Bear, Stearns transferred one half of his positions to the OTC derivatives market.¹⁶⁰ Although Kwiatkowski was making money in late 1994, on December 28, 1994, the dollar weakened dramatically, and he lost \$112 million in a few hours. Kwiatkowski posted margin for these losses and other losses during the following several weeks.¹⁶¹

More than a month later, Kwiatkowski acknowledged in writing that he was an "eligible swap participant with total assets exceeding \$10 million, and that he was familiar with foreign currency transactions."¹⁶² Bear, Stearns would have sought this acknowledgment to satisfy the Part 35 swaps exemption,¹⁶³ although it hints at some uncertainty about the exemption. In early March 1995, the dollar declined in value again, and Bear, Stearns—facing a potentially unsecured loss—liquidated all of Kwiatkowski's positions.¹⁶⁴ Kwiatkowski alleged that he lost more than \$300 million because of this hurried liquidation.¹⁶⁵

¹⁵⁸ See *id.* at *6-11.

¹⁵⁹ At one point, Kwiatkowski's positions constituted substantial percentages of the December 1994 contracts available for trading on the CME. See *id.* at *11. The court recognized that "the OTC market is a much larger market than the CME, with more participants trading more currency" and that "[t]he OTC market is also more liquid than the CME and it allows a large investor to liquidate a large position with less impact on the market than would be the case on the CME." *Id.* at *11-12.

¹⁶⁰ See *id.* at *11.

¹⁶¹ See *Kwiatkowski II*, 1999 U.S. Dist. LEXIS 19966, at *13-14.

¹⁶² See *id.* at *12.

¹⁶³ See discussion *supra* notes 62-70 and accompanying text.

¹⁶⁴ Interestingly, Bear, Stearns seems to have liquidated Kwiatkowski's positions on Sunday, March 5, 1995, a day the CME was not open. See *Kwiatkowski v. Bear, Stearns & Co.*, No. 96 Civ. 4798, 1999 U.S. Dist. LEXIS 19966 (S.D.N.Y. Dec. 29, 1999) at *14-15. The court did not discuss this fact.

¹⁶⁵ See *id.* at *15. An expert for Kwiatkowski testified that even if Kwiatkowski had begun liquidating his positions by March 1, 1995—a Wednesday, just four days earlier, when the markets were more active—he would have reduced his losses by \$139 million. See *id.* at *20. Kwiatkowski claimed he had asked Bear, Stearns to segregate his trading account from a larger account he was holding for his children; instead, Bear, Stearns used the children's account to provide leverage for the OTC derivatives transactions. See *Businessman's \$300M Fiduciary Claims*

Consider the array of questions raised by *Kwiatkowski II*. What facts are relevant in deciding whether or not a purchaser of derivatives is sophisticated? Does it matter that the purchaser is an individual, as opposed to an institution? Does it matter that the purchaser is not from the United States? Is the amount of the seller's profit from the sale of the derivatives relevant?¹⁶⁶ How and why? What is the relevance of standard form disclosures or disclaimers? Do they insulate a seller from liability? What is the effect of the (delayed) Part 35 acknowledgment? Does it matter if the disputed transaction was economically equivalent to a transaction that would not have generated losses?¹⁶⁷ Finally, how should a judge distinguish among federal statutory claims and state common law claims when there are extensive overlaps and some common elements?¹⁶⁸ *Kwiatkowski*'s claims included fraud, negligent misrepresentation, breach of contract,¹⁶⁹ and claims under the

Survive Bear Stearns' Summary Judgment Motion, DERIVATIVES LITIG. REP., Jan. 24, 2000, at 3.

¹⁶⁶ The seller's profits may be relevant in several ways. First, if the profits were very large and undisclosed, the buyer may have a claim to damages for a portion of those profits. Second, a very large profit margin may be a sign that the buyer did not understand the transaction; the argument is that if the buyer had been able to value the transaction properly, it would not have paid such a large mark-up to the seller. Alternatively, if the buyer understood the terms of the transaction, a very large profit margin is evidence that the transaction was risky or illiquid for the seller in ways the buyer might not have known and that the seller might not have disclosed. Third, the seller's profits—and particularly the individual salesperson's compensation and incentive structure—are relevant to discerning the seller's motivation to complete the transaction: was this a standard transaction the seller entered into repeatedly with other similar counterparties, or was it a kind of "this will make my year" transaction the seller only rarely was able to sell?

¹⁶⁷ For example, an OTC derivative might be economically equivalent to an exchange-traded derivative but might nevertheless generate additional losses due to illiquidity, large mark-ups, or other factors unique to the OTC markets.

¹⁶⁸ In most derivatives complaints, as in most commercial complaints generally, a long recitation of facts is followed by and incorporated into much shorter, often boilerplate, recitations of the formal claims being made in the case. In many ways, the quandary faced by a drafter of such a complaint is not so different from that faced by lawyers centuries ago; the major difference is that the choices (e.g., breach of fiduciary duty or negligent misrepresentation, as contrasted with early common law forms of complaint, e.g., trespass) have changed.

¹⁶⁹ The breach of contract claim alleged an oral agreement that was inconsistent with the terms of a written Foreign Exchange Memorandum. See *Kwiatkowski II*, 1999 U.S. Dist. LEXIS 19966, at *48.

Commodity Exchange Act,¹⁷⁰ all of which the court dismissed,¹⁷¹ as well as claims for breach of fiduciary duty and negligence, which the court allowed to proceed.¹⁷² These questions, though posed in every derivatives dispute including *Kwiatkowski II*, remain unresolved.

Such questions are difficult to answer in part because it is so impossible to know how much a judge will understand about the particular OTC derivatives market and transactions at issue. An understanding of the market is important in answering questions about a dispute. Justice Cardozo argued that fiduciary duty was closely linked to custom and practice. He wrote, "[s]ome relations in life impose a duty to act in accordance with the customary morality and nothing more. In those the customary morality must be the standard for the judge."¹⁷³ Unfortunately, the "customary morality" in derivatives markets is often complex, counterintuitive, and largely unknown to judges. In many situations, the customary morality is that derivatives counterparties owe each other no duties at all. Certainly the trillions of dollars of swap transactions between large banks do not involve expectations of any such fiduciary duty. Yet, in other instances, the customary morality is that such duties not only *are* owed but also are a precondition to the transaction. Derivatives sellers treat less sophisticated customers differently than they treat each other, for good reason. Less sophisticated derivatives purchasers rely on sellers to help them understand and access complex transactions. Such reliance is efficient; it would be too costly for every derivatives purchaser to understand every nuance to every transaction. As a result, sellers rationally *should* believe they owe *some* such duties, and their customers should not be willing to buy from them if they do not believe they were entitled to such duties. The information and sophistication gap between purchasers and sellers warrants a rule

¹⁷⁰ Kwiatkowski's CEA claims included a claim that Bear, Stearns had solicited and dealt in illegal futures transactions. This claim, which was dismissed, would have raised the complex web of issues discussed *supra* in Section 3.1.

¹⁷¹ See *Kwiatkowski v. Bear, Stearns & Co.*, No. 96 Civ. 4798, 1997 U.S. Dist. LEXIS 13078 (S.D.N.Y. Aug. 29, 1997) at *37-38 (dismissing claims pursuant to Fed. R. Civ. P. 12(b)(6)) [hereinafter *Kwiatkowski I*].

¹⁷² See *Kwiatkowski II*, 1999 U.S. Dist. LEXIS 19966, at *2-3.

¹⁷³ Benjamin Cardozo, *The Nature of the Judicial Process*, in *SELECTED WRITINGS OF BENJAMIN NATHAN CARDOZO* 107, 152 (Margaret E. Hall ed., 1947).

that the seller owes the buyer at least some limited duty in some circumstances.

Yet the courts have neither understood the implications of the "customary morality" of the derivatives industry nor the traditional analysis of fiduciary duty claims. Courts have recognized two poles of fiduciary duty analysis: one where no duties are owed and another where they are. The problem is that, in derivatives cases, courts have not clarified where the line is drawn. That failure to draw the line has generated great uncertainty.

My point here is not necessarily that the line should be drawn in a particular location as to fiduciary duty claims; I would hope that a sophisticated, fully informed judge with adequate time and resources who engaged in a careful hypothetical bargain analysis could do a fine job. Instead, my point is that the common law has failed to draw such a line at all. It may be that it is simply too difficult and costly for the judges selected to hear the relatively small number of real adjudicated derivatives disputes to draw these lines in the manner suggested here. If so, the common law of fiduciary duty as applied to derivatives-related disputes may be doomed to uncertainty.

3.2.2. *Fraud and Negligent Misrepresentation*

Derivatives complaints also have included fraud and fraud-related claims. Like fiduciary duty analysis, the treatment of fraud has deep historical roots. The common law of fraud is relatively easy to describe, even if results in individual cases are difficult to predict.

Fraud involves reliance by one party to its detriment on a material misstatement made by the other party. Fraud in the derivatives context can be relatively easy to assess. Consider, for example, the 1994 civil cases brought by the government against BT.¹⁷⁴ In related cases, the SEC and CFTC found BT had committed fraud in its dealings with Gibson Greetings and fined the bank \$10 million, in part because the derivatives were too complicated for Gib-

¹⁷⁴ See *In re BT Securities Corp.*, Exchange Act Release No. 35,136, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477, (Dec. 22, 1994); *In re BT Securities Corp.*, CFTC Docket No. 95-3, app. A, at 2 (Dec. 22, 1994). In these cases, tape recordings indicated that BT employees had lied about material elements of the transactions, including how they should be evaluated over time. Given such evidence, a fraud case can be simple, even in the derivatives context.

son Greetings employees to understand and in part because BT employees misrepresented the value of the derivatives at various points.¹⁷⁵ Similarly, the fraud claims involved in cases filed by several Korean institutions against Morgan Guaranty ("Morgan") involved complex facts but required relatively simple analysis.¹⁷⁶

However, the fact that fraud claims in derivatives cases might not be complex analytically does not necessarily mean they will be simple to resolve. The question remains as to what facts support a claim of fraud. Because the facts in derivatives cases can be difficult so can the resolution of a fraud claim. For example, Martin A. Armstrong, president of Princeton Economics International Ltd. ("Princeton"), was a defendant in several cases related to hundreds of millions of dollars of losses on structured notes¹⁷⁷ Princeton sold. Japan-based Amada Co. ("Amada") and its subsidiaries bought \$123 million of these notes from Princeton.¹⁷⁸ Amada alleged that Princeton falsely represented that the notes' value was based on Princeton's holdings of AAA-rated U.S. government securities. Amada sued in the Southern District of New York, claiming violations of federal securities laws, common law fraud, breach of fiduciary duty, and unjust enrichment.

The resolution of Amada's fraud claim depends not on any difficulties related to the law of fraud but to complex fact questions related to Princeton's representations. The key facts involve the nature of the AAA-rated U.S. government securities that formed the basis of the deals. Before the development of structured notes, the moniker "AAA-rated U.S. government security" indicated a safe, low risk investment. That indication is no longer true. Instead, such a label now says virtually nothing about the market risk of an instrument: AAA relates only to credit risk and can mask all sorts of non-credit-related risks.¹⁷⁹ Highly rated issuers, in-

¹⁷⁵ See sources cited *supra* note 174.

¹⁷⁶ See discussion *infra* notes 181-195 and accompanying text.

¹⁷⁷ Structured notes are a type of derivative instrument in which the payments of the note are linked to one or more variables using mathematical formulas. See Partnoy, *Regulatory Arbitrage*, *supra* note 1, at 220-21.

¹⁷⁸ See *Japanese Company Sues NY Bank for \$123M Alleging Investment Fraud*, 5 BANK & LENDER LIAB. LITIG. REP., Jan. 19, 2000, at 5.

¹⁷⁹ See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999).

cluding the U.S. government and its agencies, issue securities with a wide variety of market risk and leverage.¹⁸⁰

Among the most prominent recent fraud cases in the derivatives area are a series of suits filed in the Southern District of New York arising out of losses sustained by several Korean entities on purchases from Morgan¹⁸¹ of derivative instruments linked to the currency of Thailand, known as the baht. A brief recitation of some publicly available facts from these cases will show how complex even a relatively simple fraud case can become in the derivatives context.¹⁸²

In 1997, Morgan arranged a series of complex derivatives transactions for SK Securities and several other Korean counterparties. The transactions involved the establishment of Malaysian special purpose investment funds¹⁸³ that borrowed money to purchase units of a Korean trust, which then used the proceeds to purchase Korean stocks, bonds, or complex derivatives. The loans were to be repaid through a series of one-year-maturity total return swap transactions.¹⁸⁴ At the termination of these swaps, Morgan was to sell the trust units and pay the Malaysian funds the value of those units plus (or minus) an amount to be determined by reference to a formula based on a comparison of the prices of the Thai baht and Japanese yen currencies to the U.S. dollar at the dates of inception and termination of the underlying agreement,¹⁸⁵ as well

¹⁸⁰ See *id.* at 660-62.

¹⁸¹ Morgan Guaranty is a U.S.-based lending institution and a subsidiary of J.P. Morgan, a large U.S. commercial bank and one of the leading participants in the derivatives market. I served as a consultant to certain Korean entities during portions of this litigation.

¹⁸² Some of the details of these transactions are described in complaints available through the Derivatives Litigation Reporter. See, e.g., Second Am. Compl., Korea Life Ins. Co. v. Morgan Guaranty Trust Co., 99 Civ. 12175 (May 17, 2000), reprinted in 6 DERIVATIVES LITIG. REP., July 3, 2000, at A1-A11.

¹⁸³ In the derivatives market, it is very common for transactions to involve so-called "special purpose" entities, which are established solely for the purpose of a given transaction or group of transactions. See Partnoy, *Regulatory Arbitrage*, *supra* note 1, at 221-22. Such special purpose entities typically are needed so the transaction is in compliance with, or takes advantage of, a particular regulation. See *id.*

¹⁸⁴ In a total return swap, one party pays or receives the total return on some asset in exchange for paying or receiving a pre-specified periodic amount.

¹⁸⁵ Robert W. McSherry, *Candlelight, Midnight Sessions, and Dealings in the Dark: SD NY Transcript Outlines the Road to a "Complex" Settlement*, SEC. LITIG. & REG. REP., Nov. 10, 1999, at 13.

as the value of the underlying stocks, bonds, or other derivatives. Needless to say, the derivatives transactions were far from “plain vanilla” interest rate swaps.

After the Thai baht collapsed on July 2, 1997,¹⁸⁶ the valuation of the total return swaps moved dramatically against the Korean parties and in favor of Morgan. Because the Malaysian companies involved had been created only for purposes of this transaction, and therefore had no other assets, Morgan looked to the Korean com-

¹⁸⁶ There have been several substantial disputes over derivatives losses in Asia, including numerous losses related to the Thai baht collapse and ensuing crisis in Asia. This collapse in foreign exchange rates triggered a second wave of derivatives disputes, in the same way the increase in short-term interest rates in early 1994 triggered the first wave. The companies that lost large amounts of money on derivatives included: Japanese companies such as Yakult Honsha, a maker of fermented beverages, Alps Electric, a maker of electronics parts, Aoyama Trading, a fashion retailer, and Showa Shell Sekiyu K.K., an oil refiner, several large Indonesian corporate groups, including the Indah Kiat, Sinar Mas, and Tanoto groups, and several companies and corporate groups in Korea, Thailand, and Malaysia. See Bennett & Marin, *supra* note 13, at 6-7 (describing details of losses). Japanese companies in particular incurred large losses from derivative contracts. Many of these losses were not caused by any market movements but were actually the losses associated with gains previously recognized on mirror derivative contracts. In the mid-1990s, Japanese companies were notorious for engaging in sham transactions that generated immediate false accounting profits, that pushed the corresponding losses to a future date. The losses recognized by many of these companies were simply the inevitable losses associated with previous false accounting gains. For a detailed description of such transactions, see PARTNOY, F.I.A.S.C.O., *supra* note 105, ch. 10.

Japanese regulatory authorities encouraged these sham transactions during the 1990s, perhaps because they believed accurate disclosure of the companies' poor financial conditions would have hurt the economy, or perhaps because they believed the economy might improve, thereby reducing future losses. In any event the regulators abruptly changed position in 1998, even suspending one non-Japanese bank's license for selling such transactions.

Beginning in 1998, however, the financial authorities changed their regulatory posture on window dressing transactions. Responding to both international and domestic pressure to address the problems in the country's banking system, the regulators determined that window dressing was an inappropriate market practice. Because of the ambiguity of the legal and accounting framework for financial derivatives in Japan, this policy [reversal] shift was possible without any change or amendment to any regulation and without providing market participants with any advance notice. The most dramatic result of this policy . . . was the severe penalties imposed on Credit Suisse.

Bennett & Marin, *supra* note 13, at 29 (footnotes omitted).

Such an abrupt change in position adds to the regulatory uncertainty concerning financial derivatives.

panies and to four Korean guarantors to pay on the swaps.¹⁸⁷ The Korean entities refused to pay and litigation ensued.

On February 10, 1998, two of the losing parties sued Morgan in the Southern District of New York, alleging violations of federal securities laws; a few days later, Morgan sued in the same court alleging breach of contract.¹⁸⁸ The Korean entities alleged that Morgan concealed information about the transactions, including insider knowledge that the Thai central bank was preparing to allow the baht to devalue. Thus, the claims sounded in fraud.

Although numerous issues in the case were complex, one appeared to be quite simple. One of the Korean guarantor banks, Housing & Commercial Bank ("HCB"), alleged that Morgan had inserted new pages into an already initialed document, thereby changing HCB's limited guarantee of \$50 million to an unlimited guarantee.¹⁸⁹ (The losses greatly exceeded \$50 million.) Such straightforward allegations, if true, established a relatively simple case of fraud. The allegations involving the other banks were more complex but also included fraud. However, the Korean entities and Morgan had ongoing business relationships¹⁹⁰ and were able to agree to settle several of the cases.¹⁹¹ Obviously, HCB was assisted in its settlement negotiations by the fact that it was able to allege a relatively simple fraud case.¹⁹²

However, note how little value the litigation and settlement of these complex claims generated for participants in the derivatives market. Parties to the case, and more importantly their attorneys, may have, through intuition, a sense of how the judge in the cases, the Honorable Alvin K. Hellerstein, might rule in future cases. Although confidentiality orders governed the dispute, sufficient facts became public to give non-parties some sense of the factual

¹⁸⁷ The four Korean guarantors were SK Securities, Hannam Investment Securities, Housing & Commercial Bank, and Boram Bank. *See id.*

¹⁸⁸ *See id.*; *see also* J.P. Morgan Sues S. Korean Banks, Securities Firm Over Derivatives Deals, 30 SEC. REG. & L. REP. (BNA) 282 (Feb. 20, 1998) (detailing J.P. Morgan's lawsuit against South Korean banks).

¹⁸⁹ *See Korean Bank: Morgan Fudged*, BOND BUYER, Apr. 27, 1998, at 1.

¹⁹⁰ The transcript of the settlement conference describes the parties as "business partners." *See* McSherry, *supra* note 185, at 13.

¹⁹¹ J.P. Morgan & Co., parent of Morgan Guaranty, agreed to purchase a substantial stake in SK Securities and to forgo payment of the \$300 million it was owed. The value of the settlement was estimated at \$250 million. *See id.*

¹⁹² *See Morgan Fudged*, *supra* note 189, at 1.

basis for the fraud claims. But because the parties settled the case subject to a confidentiality agreement, Judge Hellerstein's role was simply to grant the stipulated dismissal¹⁹³ without a detailed opinion. Neither he nor any other judge in New York would be bound by his actions in this series of cases. Nor would any future party benefit from any of the wisdom or judgment Judge Hellerstein accumulated during the litigation. Notwithstanding the millions of dollars of legal fees spent to resolve one of the largest derivatives disputes in history, the result was absolutely no common law—not a single legal rule—of use to future parties.

Not every Korean entity settled its claims, and there are ongoing disputes involving Morgan, so there is some chance a common law precedent will still be established. In a related case also before Judge Hellerstein, Korea Life Insurance Co. ("KLI") sued Morgan for fraud, unjust enrichment, frustration of commercial purpose, negligent misrepresentation, lack of authority, breach of the duty of good faith and fair dealing, and violation of the New York gaming laws.¹⁹⁴ In this suit, KLI seeks approximately \$100 million in damages it allegedly incurred on derivatives linked to the Thai baht and Japanese yen.¹⁹⁵ Part of the fraud claim in KLI's complaint relates to the structure of the transaction; part of the claim relates to Morgan's use of information it procured to the disadvantage of KLI without disclosing that information in advance.¹⁹⁶ This latter argument has empirical support; there is evidence of dealers acting to take advantage of information in the foreign exchange markets to the detriment of their counterparties.¹⁹⁷

¹⁹³ See *id.*

¹⁹⁴ See *Korean Insurer's NY Swaps Suit Seeks \$350M from Morgan Guaranty Trust Co.*, 6 DERIVATIVES LITIG. REP., Jan. 24, 2000, at 7.

¹⁹⁵ See *id.* (describing negative effect of devaluation of Thai baht on the investment).

¹⁹⁶ See Second Amended Complaint, *supra* note 182, at 6-14.

¹⁹⁷ For example, in early 1995, when the Japanese yen appreciated towards the "knock-out" levels relevant to a series of structured derivatives transactions, dealers had an incentive to push the value of the yen up through these levels and thus eliminate their obligations on the transactions. See STEINHERR, *supra* note 1, at 109. There is evidence that dealers did precisely this. See A.M. Malz, *Currency Option Markets and Exchange Rates: A Case Study of the U.S. Dollar in March 1995*, 1 CURRENT ISSUES IN ECON. & FIN. No. 4 (July 1995) (describing substantial increase in such transactions during the relevant period of time).

Judge Hellerstein has a unique opportunity in this suit to contribute an important common law decision to the global derivatives market, an opportunity Holmes would have relished. The case was pending as of late 2001.

In addition to "straight" fraud claims, fraud-related complaints often include claims filed under the heading "negligent misrepresentation." The law of negligent misrepresentation is more complex than that of fraud and generates some additional difficulties in derivatives disputes. Nevertheless, the analysis of negligent misrepresentation claims, and the duties required for such claims, parallels that of fiduciary duty claims.¹⁹⁸

In general, a defendant is liable for negligent misrepresentation only from the breach of a duty running to the injured plaintiff.¹⁹⁹ Specifically, in the commercial context, this rule means that to be liable a defendant must "possess unique or specialized expertise, or . . . [be] in a special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation is justified."²⁰⁰ The facts that justify a finding of such special position include whether the person making the representations knew how the information would be used and whether this person appeared to hold a position of trust and confidence.²⁰¹

New York courts have distinguished between: (1) commercial actors such as insurance agents, who are not in a better position than their client insureds to know the insured's personal assets and ability to protect themselves; and (2) other providers of services, such as doctors, attorneys, or architects, who are in a better position than their clients to know and understand such information.²⁰²

¹⁹⁸ See, e.g., *Pinky Originals, Inc. v. Bank of India*, No. 94 Civ. 3568, 1996 U.S. Dist. LEXIS 15575, at *78 (S.D.N.Y. Oct. 21, 1996) (grouping together negligent misrepresentation and fiduciary claims and noting that "plaintiffs' claims premised on negligent misrepresentation, failure to disclose, and breach of fiduciary duty are dependent on a showing that the Bank owed some fiduciary duty to the plaintiffs").

¹⁹⁹ See, e.g., *Kimmell v. Schaefer*, 89 N.Y.2d 257, 263 (1996) ("Liability for negligence may result only from the breach of a duty running between a tortfeasor and the injured party.").

²⁰⁰ *Id.*

²⁰¹ *Id.* Professionals, including lawyers and accountants, are subject to higher duties. *Id.* at 263-64.

²⁰² See, e.g., *Murphy v. Kuhn*, 90 N.Y.2d 266 (1997) (affirming grant of defendant's motion to dismiss plaintiff insured's claims for tortious misrepresentation and breach of implied contract).

The cases do not specifically mention derivatives dealers. The question remains whether (and when) a buyer of derivatives is “at a substantial disadvantage to question the actions of the provider of services.”²⁰³

When might a derivatives purchaser be at a substantial disadvantage to question the actions of the seller? The cases seem to indicate that when a sophisticated party is “ripped off” by another sophisticated party, there is no cause of action.²⁰⁴ However, cases are less clear about facts that do not rise to the level of fraud or breach of fiduciary duty, yet involve one party that is more sophisticated than the other and therefore might support a negligent misrepresentation claim.

For example, in *Kwiatkowski II* there was evidence of a “substantial advisory relationship”²⁰⁵ between the purchaser and seller. Does providing financial advice trigger a duty that would support a negligent misrepresentation claim? It is difficult to know how to draw such a line. Courts have not done it, and lawyers pressing such claims have had difficulty articulating any such line. In both *Press* and *Independent Order of Foresters*, the courts criticized the formulation and drafting of the complaint as inadequate.²⁰⁶ In contrast, in *Kwiatkowski II* the district court made great use of the detailed allegations in the complaint and favorably cited the testimony of several experts: (1) that the plaintiff was exposed to an excessive risk of loss; (2) that based on existing industry standards the defendants should have advised him of this risk; (3) that the defendants did not provide sufficient supervision or monitoring of the plaintiff’s positions; and (4) that the defendants failed to develop an appropriate “exit strategy” for liquidating the contracts.²⁰⁷

²⁰³ *Id.*

²⁰⁴ See *Compania Sud-Americana de Vapores, S.A. v. IBJ Shroder Bank & Trust Co.*, 785 F. Supp. 411, 426 (S.D.N.Y. 1992) (calling the suit by a plaintiff who was charged very high mark-ups in foreign currency transactions “merely an effort to avoid the repercussions of its lack of diligence in monitoring the rates at which conversions were made for over six years”).

²⁰⁵ See *Kwiatkowski II*, 1999 U.S. Dist. LEXIS 19966, at *33.

²⁰⁶ See *Indep. Order of Foresters v. Donalds, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 937-38 (2d Cir. 1998) (pointing out absence and limitation of allegations); see also *Press v. Chem. Inv. Servs. Corp.*, 988 F. Supp. 375, 386-87 (S.D.N.Y. 1997) (characterizing the complaint as a “naked allegation”).

²⁰⁷ See *Kwiatkowski II*, 1999 U.S. Dist. LEXIS 19966, at *39.

Thus, the difference in the cases may be due more to the quality of the lawyering than to any distinguishing feature of fact or law.

The differences in these cases present some bitter ironies. Perhaps the existence of a duty depends more on the quality of the lawyering than on the facts in a particular case. Perhaps it is easier for a judge to jettison a case on a motion to dismiss, before the parties have had a chance to gather evidence, than on a motion for summary judgment, even though the law states that allegations made in a complaint are assumed to be true for purposes of deciding a motion to dismiss. In any event, judges and lawyers faced with fraud-related claims in derivatives cases have had a difficult time, and the result is pitiful: increased uncertainty for participants in the derivatives market and virtually no common law guidance.

3.2.3. *Lack of Authority*

The once-important topics of agency and authority receive short shrift in law school today.²⁰⁸ Yet in recent derivatives disputes, authority issues have been important, even dispositive.

The authority argument in the context of derivatives is relatively simple. A financial derivative transaction is simply a contract, typically between two parties. If one party did not have legal authority to enter into that contract, it is not binding on that party.

Alternatively, even if the party did not have *actual* legal authority, the party might be bound if there was *apparent* authority. Apparent authority is a common law concept holding that a principal may be bound by the actions of an agent who does not have actual authority when the principal acts in a way that reasonably could lead a third party to conclude that the principal consented to the agent's exercise of authority.²⁰⁹

²⁰⁸ Many schools do not offer courses in agency, although the topic receives brief treatment at the beginning of many corporate law casebooks. See, e.g., WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 33-45 (4th ed. 2000) (discussing agency and apparent authority); see also MELVIN A. EISENBERG, AN INTRODUCTION TO AGENCY AND PARTNERSHIP 1-27 (2d ed. 1995) (introducing agency and the agent's authority and duties).

²⁰⁹ See, e.g., JAMES D. COX ET AL., CORPORATIONS 129-30 (1997) (describing apparent authority).

Plaintiffs have claimed in derivatives disputes that the underlying transactions were illegal or unauthorized.²¹⁰ For example, in *Sumitomo Corp. v. J.P. Morgan & Co.*,²¹¹ Sumitomo argued both: (1) that derivatives financing transactions entered into by an individual trader were unauthorized because only Sumitomo's treasury department—not any individual trader—could authorize financing on behalf of Sumitomo; and (2) that the transactions were prohibited by Japanese law.²¹² These two claims—lack of authority and illegality—are often put together. Lack of authority stems from the fact that a grant of authority was illegal; illegality, in turn, implies that an individual lacked authority.

Courts have held that contracts made in violation of a country's law (or with a view of being in violation of that country's law) are unenforceable.²¹³ In *Sumitomo Corp. v. J.P. Morgan & Co.*, for example, a Sumitomo copper trader, Yasuo Hamanaka, obtained financing from J.P. Morgan without the approval of Sumitomo's treasury department or board of directors. Sumitomo's argument was that if approval was required and not given, the transactions were null and void. Alternatively, Article 260 of the Japanese

²¹⁰ The first prominent derivatives case in the area was a British case holding that derivatives transactions entered into by the London boroughs of Fulham and Hammersmith were contrary to law. *Hazell v. Hammersmith & Fulham London Borough Council*, 2 W.L.R. 372 (H.L. 1991). The state of West Virginia raised similar claims in *West Virginia v. Morgan Stanley*. *State v. Morgan Stanley & Co.*, 459 S.E.2d 906 (W. Va. 1995). Authority issues also arose in the Orange County litigation. Orange County sued the brokers who sold it certain derivatives and alleged that the transactions were *ultra vires*, or beyond the limits of the law. The specific allegation was that the investment strategy was so risky it violated California law and that the brokers had a duty to halt their business dealings with Orange County and report the activities. See *Orange County, Brokers File Cross-Motions for Summary Judgment*, DERIVATIVES LITIG. REP., Oct. 15, 1998, at 5. Orange County also claimed that certain reverse repurchase transactions it entered into with the brokers violated state law and would have required voter approval. *Id.*

²¹¹ See *Sumitomo Corp. v. J.P. Morgan & Co.*, No. 99 Civ. 8780, 2000 U.S. Dist. LEXIS 1252 (S.D.N.Y. Feb. 7, 2000).

²¹² See Memorandum of Plaintiff Sumitomo Corporation in Opposition to Defendants' Motion to Dismiss Certain Claims in the Complaint at 32, *Sumitomo Corp. v. J.P. Morgan & Co.*, No. 99-CV-8780 (S.D.N.Y. May 25, 2000) [hereinafter *Sumitomo Memorandum*] (on file with author).

²¹³ See, e.g., *Rutkin v. Reinfeld*, 229 F.2d 248, 255 (2d Cir. 1956) (commenting that a contract entered into "with a view of violating the laws of another country . . . is unenforceable"); *Dornberger v. Metro. Life Ins. Co.*, 961 F. Supp. 506, 532-38 (S.D.N.Y. 1997) (stating that a contract made in violation of European law was subject to rescission).

Commercial Code prohibited such financing transactions without approval of the board of directors.²¹⁴ According to this argument, if Japanese law required board approval and approval was not given, then the transactions were illegal, and therefore were void.

Authority issues also can arise based on the scope of an investment agreement between two parties, where one is investing in derivatives on behalf of the other. For example, AT&T Corp.'s pension plan and the Massachusetts Pension Reserves Investment Trust lost a combined \$162 million based on unauthorized trading by the chief investment officer of Rhumblin Advisers, an investment adviser the two pension funds were using.²¹⁵

Authority issues have arisen in recent derivatives disputes in Asia. For example, Indonesian corporations often have a two-tiered board structure and articles of association requiring that major financial transactions be approved by both boards—the board of directors, which has general executive authority, and the board of commissioners, which oversees and advises the directors.²¹⁶ Unfortunately, Indonesian law and most articles of association are unclear about when the board of commissioners must approve a transaction. Although in theory, a party could eliminate authority-related risk by requiring the board of commissioner's approval, most Indonesian companies balk at obtaining such approval.²¹⁷

Plaintiffs in derivatives disputes often include, along with lack of authority claims, an argument that the derivatives were not suitable investments.²¹⁸ The underlying rationale for suitability

²¹⁴ Article 260 provides that "[t]he Board [of Directors] cannot delegate the following decisions to a manager, but must itself make them: . . . (2) Borrowing a substantial sum of money." 12 COMMERCIAL LAWS OF THE WORLD 40 (Foreign Tax Law Pubs. 1993). The amount borrowed in this case was approximately \$283 million (in Japanese yen) arguably a "substantial sum." Sumitomo Memorandum, *supra* note 112, at 33.

²¹⁵ See *Orange County*, *supra* note 110, at 5.

²¹⁶ See Bennett & Marin, *supra* note 13, at 30 n.121 (citing advice received by the authors from the Jakarta law firm of Ali Budiardjo, Nugroho, Reksodiputro).

²¹⁷ See *id.* at 31 n.123.

²¹⁸ See Bennett & Marin, *supra* note 13, at 35. For a recent general discussion of suitability claims in the securities context, see Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999). There are numerous articles about derivatives and suitability. See, e.g., Geoffrey B. Goldman, *Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed?"*, 95 COLUM. L. REV. 1112

claims is similar to that for breach of fiduciary duty: the seller has the information, knowledge, or sophistication advantage over the purchaser and, therefore, owes the purchaser a duty not to mislead him or her about the risks of the instrument and, in any event, not to sell instruments that are too complicated for a particular purchaser to understand.²¹⁹ Unfortunately, no jurisdiction has clarified what circumstances or facts would generate such a duty owed by a derivatives seller to the buyer.

Derivatives purchasers have brought an array of common law claims based on the notion that the instruments were not suitable. For example, in *UBS International Trustees Ltd. v. Morgan Stanley Dean Witter & Co.*,²²⁰ the plaintiff alleged, as trustee on behalf of the purchaser who lost money on the instruments, that the purchaser was not sophisticated in the use of leverage and derivatives.²²¹ These suitability allegations supported common law claims of fraud, misrepresentation, and breach of fiduciary duty. In *Springwell Navigation Corp. v. The Chase Manhattan Bank*,²²² the plaintiff alleged breach of contract, breach of fiduciary duty, fraudulent misrepresentation, negligent misrepresentation, professional negligence, and negligent supervision, all based on the defendant's failure to inform the plaintiff that investments in certain emerging markets bond derivatives²²³ were very risky and unsuitable for the plaintiff's goals.²²⁴

(1995); Lyle Roberts, *Suitability Claims Under Rule 10b-5: Are Public Entities Sophisticated Enough to Use Derivatives?*, 63 U. CHI. L. REV. 801 (1996).

²¹⁹ This rationale is not based on some notion of fairness to particular purchasers. Rather, it is an economic-based gap-filling rationale designed to benefit the derivatives industry as a whole. Without some such perceived protection, purchasers might not transact.

²²⁰ *UBS Int'l Trs. Ltd. v. Morgan Stanley Dean Witter & Co.*, No. 99 Civ. 8957 (S.D.N.Y. amended complaint filed Dec. 20, 1999).

²²¹ See, e.g., *U.K. Investment Co.'s Amended Complaint Names Morgan Stanley Director*, SEC. & COMMODITIES LITIG. REP., Jan. 26, 2000, at 7 (describing the sophistication difference between a derivatives purchaser and Morgan Stanley).

²²² See *Springwell Navigation Corp. v. Chase Manhattan Bank*, No. 99 Civ. 11855 (S.D.N.Y. complaint filed Dec. 7, 1999).

²²³ A large portion of the plaintiff's money was used to buy Russian derivatives consisting of CMSCI Notes, which were tied to Russian government short-term zero coupon ruble-denominated bonds known as Gosudarstvenniye Kratkosrochniye Obligatsii, or GKO's. See *Greek Company Sues Chase Manhattan over \$200M Bond Derivatives Loss*, DERIVATIVES LITIG. REP., Jan. 10, 2000, at 4. Interestingly, the complaint's description of the derivative instrument was incomplete, presumably because either the plaintiff or the lawyers or both were unable to un-

Unfortunately, the legal basis for suitability claims is wrought with ambiguity and confusion. Under U.S. law, suitability claims typically arise out of "securities" transactions only. The National Association of Securities Dealers has adopted suitability rules, including rules extending suitability obligations to broker-dealers selling securities to institutional customers.²²⁵ Outside of the United States, the law is even less clear, and there are no guidelines or standards describing the suitability obligations of a derivatives seller.²²⁶ As in other areas of derivatives litigation, disputes over suitability typically are settled before judicial decision or trial.²²⁷

It is unclear whether suitability claims fit under breach of fiduciary duty²²⁸ or lack of authority²²⁹ or whether they are even relevant in OTC derivatives disputes. Courts facing lack of authority claims have not clarified the issue.

3.2.4. Contract-Based Claims

Finally, derivatives disputes often involve claims for breach of contract. A breach of contract claim can be relatively straightforward, even in the derivatives context. For example, in a 1997 state court case in Maryland, a judge awarded \$1.7 million to two businessmen who lost money on several currency swaps with FX Concepts Inc.²³⁰ FX Concepts claimed to have a sophisticated computer

derstand and describe it. *See id.* ("The value of the Note was linked in as yet an unexplained way to the value of the underlying GKO's.").

²²⁴ *See id.*

²²⁵ *See* Order Granting Proposed NASD Suitability Rule Change, Exchange Act Release No. 34-37588, 61 Fed. Reg. 44,100 (Aug. 20, 1996).

²²⁶ *See* Bennett & Marin, *supra* note 13, at 36 (noting that in Asia "[t]he local legal systems contain neither guidelines on what constitutes a suitable derivative nor express obligations on the part of a seller of a derivative instrument to ensure that the instrument is suitable for the buyer in light of its particular circumstances").

²²⁷ *See id.* at 36 n.150, 38 n.160 (citing examples of suitability claims by TPI Polene PLC, a Thai plastic and cement maker, against UBS and claims by SK Securities, a Korean firm, against J.P. Morgan & Co., both of which settled for undisclosed amounts).

²²⁸ The question in this case would be whether unsuitable trades were made in violation of a duty owed by seller to buyer.

²²⁹ The question in this case would be whether unsuitable trades were beyond the authority of a purchaser.

²³⁰ *Currency Swaps: Investors Win \$1.7 Million Award on Md. Claim Against Management Firm*, 29 SEC. REG. & L. REP. (BNA) 1455 (Oct. 17, 1997).

model that identified winning foreign currency bets.²³¹ An official of FX Concepts had instructed the employee dealing with the two businessmen to tell them about certain risks in European currencies and that employee failed to do so. The court found that failure to deliver this instruction was a breach of contract.²³²

I have found only one case involving OTC derivatives that went to trial, and that case essentially presented a breach of contract claim. Although numerous other claims were involved in the case, the verdict is based primarily on a breach of contract rationale. Unfortunately, this case provides no certainty at all to a prospective derivatives investor, and, in fact, contains confusing and contradictory statements about the applicable derivatives transactions.

This case, *BankAtlantic v. Blythe Eastman Paine Webber, Inc.*,²³³ involved two interest rate swaps between two financial institutions: BankAtlantic and Homestead Savings, with PaineWebber serving as a broker to BankAtlantic. BankAtlantic lost more than \$30 million on the swaps, and sued PaineWebber for breach of contract, breach of fiduciary duty, fraud, fraudulent concealment, negligence, and negligent misrepresentation. After a five-week jury trial in 1989, the jury returned a verdict in favor of PaineWebber. BankAtlantic appealed on various grounds, and the Eleventh Circuit affirmed.²³⁴

The opinion is notable, not for its analysis of any particular legal issues, but for how little guidance it provides to any derivatives market participant. The relevant portion of the Eleventh Circuit opinion is as follows:

Based on PaineWebber's recommendation, BankAtlantic entered into the two interest rate swaps with Homestead Savings ("Homestead") in an effort to hedge its adjustable rate deposit payables against an increase in interest rates. Alleging non-performance under the agreement, BankAtlantic terminated the services of PaineWebber as financial

²³¹ *Id.*

²³² *Id.*

²³³ *BankAtlantic v. Blythe Eastman Paine Webber, Inc.*, 955 F.2d 1467 (11th Cir. 1992).

²³⁴ *Id.* at 1469.

advisor and employed another firm to assist with the interest rate swaps. During this time, interest rates were falling drastically, allegedly causing BankAtlantic to suffer losses in excess of \$30 million.

In August 1987, BankAtlantic brought suit against PaineWebber alleging these losses were caused by PaineWebber's failure to disclose the risks involved in interest rate swaps, e.g., that if interest rates fell, the high yielding fixed rate mortgages would be prepaid as borrowers refinanced. BankAtlantic also alleged that PaineWebber failed to disclose its extensive relationship with Homestead, that Homestead was not creditworthy and therefore that BankAtlantic should have obtained collateral from Homestead.²³⁵

That is the relevant discussion, in its entirety. The remainder of the opinion is no more illuminating and neither is the district court's three-page opinion and order denying the plaintiff's assertions of error, motion for judgment notwithstanding the verdict, and motion for a new trial.²³⁶ Consider the questions someone considering a derivatives transaction would have about this case: What were the basic terms of the interest rate swap? Did BankAtlantic agree to pay a fixed rate and receive a floating rate, or vice versa? If BankAtlantic lost money when interest rates dropped, how were the swaps designed to hedge against an increase in interest rates? If these were truly interest rate swaps, what did the prepayment risk associated with fixed rate mortgages have to do with the transaction? How was Homestead's credit and collateral related to BankAtlantic's losses? Did BankAtlantic lose money because the swaps moved in its favor and Homestead defaulted, or because the swaps moved against BankAtlantic? What was the relationship of the parties, and was it relevant? Were there alleged

²³⁵ *Id.* at 1469-70.

²³⁶ See *BankAtlantic v. Blythe Eastman Paine Webber, Inc.*, 130 F.R.D. 153 (S.D. Fla. 1990), *aff'd* 955 F.2d 1467 (11th Cir. 1992) (three-page opinion, less than one page of which considers the plaintiff's motions).

misrepresentations? A party looking for guidance from this case will not find answers.

Other contract-based claims have been for excessive fees charged in derivatives deals. Between 1994 and 1997, Slovnaft A.S., the former Slovak national oil company, purchased four structured loans from Merrill Lynch International, Inc. and lost \$175 million.²³⁷ Slovnaft sued Merrill in 1999 in New York state court alleging that crude oil-linked derivatives embedded in the loans had cost Slovnaft \$75 million in "exorbitant" interest payments.²³⁸

Contractual duties can arise out of obligations described in standard form agreements signed by both parties. These agreements can serve as the basis for claims based on implied contractual duties. Judge Feikens found support for such a claim in the *Procter & Gamble Co. v. Bankers Trust Co.* case. In that case, section 4 of the standard form ISDA agreement between the parties provided that each party must furnish specified information and that such information must also relate to any documents specified in the confirmation.²³⁹ In other words, the specification of such information in the standard form created a duty to furnish the specified information.

New York case law establishes such an implied contractual duty to disclose in business negotiations. As Judge Feikens read this duty, it may arise where: "(1) a party has superior knowledge of certain information; (2) that information is not readily available to the other party; and (3) the first party knows that the second party is acting on the basis of mistaken knowledge."²⁴⁰ Such a duty

²³⁷ *Merrill Lynch*, *supra* note 120, at 10.

²³⁸ See *Slovnaft A.S. v. Merrill Lynch Int'l, Inc.*, No. 603760-99 (N.Y. Sup. Ct. 1999).

²³⁹ Judge Feikens wrote in *Procter & Gamble*:

Documents that are referred to in the Confirmation (here I allude specifically to the documents that will enable a party to determine the correlation between the price and yields of the five-year Treasury notes and thirty-year Treasury bonds, the sensitivity tables, the spreadsheets regarding volatility, and documents relating to the yield curve) should be provided.

Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1290 (S.D. Ohio 1996).

²⁴⁰ See *id.* (citing *Banque Arabe et Internationale D'Investissement v. Md. Nat'l Bank*, 57 F.3d 146 (2d Cir. 1995)).

to disclose may arise even in the absence of a fiduciary duty between the parties.²⁴¹ Judge Feikens concluded "that defendants had a duty to disclose material information to plaintiff both before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith during the performance of the swap transactions."²⁴²

As a result, even if the duty-based claims for breach of fiduciary duty, negligent misrepresentation, and suitability fail, an implied breach of contract claim may survive based on obligations created by swap documentation. Analytically, this result makes little sense. These claims all are based on essentially the same rationale²⁴³—that sophistication or information asymmetry will support a duty to disclose material facts. This rationale is wrapped in different packages, each with a different jurisprudence and each with a small set of indeterminate cases. Not surprisingly, it is very difficult for parties to derivatives transactions—even if they agree on the facts—to know how or why a judge will resolve their dispute.

3.3. *The Limited Applicability of Private Law*

The remaining two alternatives merit only brief consideration. They have presented only a handful of issues relevant to derivatives disputes.

The implied breach of contract claim in the P&G case just discussed is a rare instance of a claim arising out of a private derivatives contract. These contracts are form agreements created by derivatives dealers and their lawyers, and—not surprisingly—are structured to ensure that derivatives contracts are not subject to federal regulation and to prevent the survival of most non-dealer derivatives parties' claims in a dispute with a dealer.²⁴⁴

Private law has evolved in the derivatives area along two paths. The first path, designed for transactions between deriva-

²⁴¹ See *id.* (citing numerous New York cases).

²⁴² *Id.* at 1291.

²⁴³ An additional rationale not yet addressed in any derivatives dispute is commercial frustration or impracticability. See *supra* note 115 and accompanying text.

²⁴⁴ For a general description of such contract-based efforts in the securities context, see Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879 (1994).

tives dealers, has ended in a very complete, self-regulatory mechanism of little relevance in the derivatives disputes discussed here. For private law enthusiasts, these packages of default rules are things of beauty. The standard form contract, created by ISDA, is a complete, well-constructed private law governing most contingencies that might arise between dealers.²⁴⁵ It is flexible, yet comprehensive, and is a standard within the industry. However, because few derivatives disputes are between dealers, it is largely irrelevant for purposes of this discussion.

The second path, designed for transactions between dealers and non-dealers, is much shorter, ending in a relatively small number of non-reliance provisions included in the standard ISDA documentation, as well as in other documentation related to derivatives transactions between dealers and non-dealers, including term sheets, economic reports and forecasts, and analysis of particular trades, including "scenario analysis."²⁴⁶ These non-reliance provisions, or "disclaimers," which are virtually the same in every derivatives transaction, purport to absolve the dealer of liability associated with the transaction.²⁴⁷ A typical disclaimer says something like "the purchaser fully understands the above terms and conditions, including the risks and benefits of the transactions."

Derivatives sellers argue that if they obtain a signed disclaimer of a duty and/or provide adequate scenario analysis, a purchaser should not be able to sustain the common law claims articulated in Section 3.2. For example, derivatives sellers argue that if a buyer represents that the seller owes no duty to him or her, the buyer cannot later sue to recover on a duty-based theory; similarly, a buyer cannot later complain about oral misrepresentations if they

²⁴⁵ The basic form contract is the 1992 ISDA Master Agreement (Local Currency—Single Jurisdiction). There also are more complex standard forms, forms in translation, as well as recent annexes with updated definitions. The basic form is available to non-members through the ISDA website for \$25; the complete set of forms is \$1,600. See International Swaps and Derivatives Association Inc., <http://www.isda.org/index.html> (last modified 2000).

²⁴⁶ Analysis of particular trades includes "scenario analysis," which describes the gains and losses on a particular derivative transaction based on changes in one or more variables. For example, scenario analysis for a swap based on a particular index might show the financial position of the purchaser given an increase or decrease of one, two, and five percent in the index.

²⁴⁷ Courts have upheld such non-reliance clauses in the securities context. See, e.g., *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000) (holding that a written non-reliance clause prohibited recovery based on prior oral statements).

are inconsistent with a later-signed written statement accurately setting forth the substance of the allegedly misrepresented facts.

There is an initial question about whether disclaimers actually are negotiated provisions that should be enforced against buyers. If some derivatives contracts were sold with disclaimers and others were not, there would be an argument that the disclaimers were both negotiated and priced by the parties. It is more difficult to make this argument when there is unanimous use of essentially similar disclaimers. It seems incredible to argue that each such disclaimer was priced and negotiated in a multi-billion dollar contract. Neither is it credible to argue that it is sufficient if a small number of disclaimers are priced and negotiated because then all contracts would reflect those prices and negotiations; such an argument makes little sense in a market consisting of privately negotiated, often confidential transactions.

However, even if one assumes that the disclaimers were negotiated and are not adhesion contracts, there are other strong reasons to believe neither a signed disclaimer nor a detailed scenario analysis should preclude a duty-related claim. First, disclaimers or scenario analyses may be misleading, inadequate, or fail to disclose important information the seller possesses that the buyers do not.²⁴⁸ For example, prior to the Asian crisis, numerous investment and commercial banks had information about specific countries' central bank practices and currency reserves and were in fact taking large speculative positions based on this information. Any bank selling derivatives based on foreign exchange rates in those countries would have an obvious information and knowledge advantage. If the bank did not disclose this information, and made other disclosures (including scenario analysis) that would be made misleading by this information, any purchaser of derivatives from the bank would have a strong argument that the bank owed that purchaser a duty (because of the superior information and knowledge) and it breached that duty (because of the omissions and misrepresentations).

In addition, a disclaimer must be sufficiently specific to disclaim the misrepresentations and omissions that form the basis of a

²⁴⁸ See, e.g., Bennett & Marin, *supra* note 13, at 39 ("A scenario analysis that is based on historical volatility, for example, may prove to be inadequate if markets move in an unexpected manner.").

purchaser's claim. For example, the Second Circuit has held that the contract language must "match the alleged fraud."²⁴⁹ The New York appellate courts have held that a disclaimer of reliance on representations must be specifically related to the contents of the fraud claim.²⁵⁰ For example, disclaimers related to the "physical nature of the premises" and "environmental matters" were not sufficiently specific to preclude a fraud claim based on the "presence of underground tanks containing possible toxic chemicals."²⁵¹

The policy behind these cases is, consistent with hypothetical bargain analysis, that purchasers would not willingly accept a broad disclaimer absent some reduction in price or increase in quality. At the extreme, purchasers cannot (and would not *ex ante*) disclaim fraud. Accordingly, such disclaimers should be read narrowly, especially when the parties were in a situation involving information or sophistication asymmetry.

To the extent disclaimers arise as issues in derivatives disputes, they should be read narrowly and certainly should not be read to preclude purchaser claims based on inaccurate or misleading statements. Even ISDA, the dealers' own organization, has recognized this principle.²⁵² No court has yet published an opinion on this issue in a derivatives dispute. The first judge to do so should carefully consider the implications of informational asymmetry in a hypothetical bargain analysis and should not simply accept a dealer's attempts to skirt a principle in a dispute that it previously had endorsed through ISDA as good policy.

3.4. *Some Attempts at Arbitration*

Given the problems associated with the alternative means of resolving disputes, one might expect derivatives counterparties to

²⁴⁹ See *Mfrs. Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 317 (2d Cir. 1993) ("Where the fraud claim has been dismissed, the disclaimer has been sufficiently specific to match the alleged fraud.").

²⁵⁰ See *Hi Tor Indus. Park, Inc. v. Chem. Bank*, 494 N.Y.S.2d 751 (N.Y. App. Div. 1985) (finding disclaimer clauses ineffective to bar the consideration of parol evidence of misrepresentation unless the clauses refer to the particular subject matter with sufficient specificity).

²⁵¹ See *id.* at 752.

²⁵² See Raj Bhala, *Applying Equilibrium Theory and the FICAS Model: A Case Study of Capital Adequacy and Currency Trading*, 41 ST. LOUIS U. L.J. 125, 209 n.369 (1996) (citing ISDA's strong recommendation that U.S. members follow the ISDA Principles and Practices for Wholesale Financial Market Transactions).

sign arbitration clauses. Yet arbitration of such disputes is rare. One reason may be that both counterparties fear the uncertainty associated with an arbitrator even more than they fear the courtroom. The recent evidence of New York Stock Exchange arbitration panels ruling against Wall Street investment banks in ways the banks did not expect would support this reason.²⁵³

Another reason may be that more sophisticated counterparties may prefer the less fair forum of court precisely because it is more expensive. In court, a derivatives dealer can force a plaintiff to engage in expensive litigation, which the dealer easily can afford but the purchaser may find more difficult to sustain, especially given the expense of discovery. Delay typically works to the dealer's advantage. If the case seems to be moving in the plaintiff's favor, the dealer can, and will, simply settle to avoid an adverse ruling.

There is little evidence of derivatives disputes moving from court to arbitration. On the other hand, it seems clear that parties to a derivatives contract may effectively incorporate external law into an arbitration agreement or may authorize an arbitrator to decide such questions of external law.²⁵⁴ Parties also may, by agreement, establish discovery rules, including rules resembling those applicable to disputes in federal court.²⁵⁵ These benefits might make arbitration more attractive to derivatives market participants.

The evidence of arbitration agreements in the derivatives market is scant and very recent. In late 1999, Panama-based Dorigol S.A. agreed to arbitrate a derivatives dispute with J.P. Morgan & Co. before a National Association of Securities Dealers panel.²⁵⁶ Dorigol had filed suit in the Southern District of New York, alleg-

²⁵³ See Randall Smith, *Losing a Job on Wall Street These Days Often Doesn't Mean Losing a Bonus, Too*, WALL ST. J., July 19, 2000, at C1, C4 (citing several awards to employees in bonus disputes with their employer bank).

²⁵⁴ See LAURA J. COOPER ET AL., ADR IN THE WORKPLACE 153 (2000) ("No one doubts that the parties may authorize the arbitrator to decide external law questions, either by incorporating the law in the . . . agreement or by posing the external law issue in the submission agreement."). Where private parties have not indicated that particular external law should govern, arbitrators are not constrained by external law or cases. See *id.* at 247 (noting that "arbitrators usually do not treat as conclusive the determinations of administrative agencies or courts").

²⁵⁵ See *id.* at 225 (describing contract assuring parties access to "all nonconfidential information as is relevant and appropriate to the negotiation, maintenance and enforcement of this agreement").

²⁵⁶ See *Panamanian Firm, J.P. Morgan Agree to Arbitrate \$7M Derivatives Case*, 5 SEC. LITIG. & REG. REP., Jan. 12, 2000, at 8.

ing J.P. Morgan committed fraud when it sold Dorigol OTC call and put option on Brady bonds without disclosing facts it knew about risks in that market.²⁵⁷ Specifically, Dorigol alleged J.P. Morgan knew it was going to issue a margin call against Long-Term Capital Management in late 1998 and that such a margin call would cause the market for emerging market bonds to collapse.²⁵⁸ In fact, this market did collapse, and Dorigol ultimately lost \$7 million on the trades.²⁵⁹

Although attorneys for J.P. Morgan were advocating the move from court to arbitration, attorneys for Dorigol also suggested they might be better off with an arbitration panel.²⁶⁰ Resisting arbitration would have been expensive and not necessarily in Dorigol's best interest. Morgan did not disclose its motives in moving to arbitration.

In a similar case, in early 2000, Lehman Brothers Inc. filed a motion asking the Southern District of New York to stay a suit against Lehman and to compel arbitration.²⁶¹ The plaintiff, Banco Disa S.A., a Panamanian bank, had filed suit alleging common law breach of fiduciary duty, fraud, and negligent misrepresentation, as well as fraud and misrepresentation under Section 10(b) of the Securities Exchange Act, for losses it incurred on several investments in U.S. Treasury-based derivatives.²⁶² Again, the parties' motivations were unclear.

The defendant banks may have been motivated by very large, recent settlements other banks had agreed to pay in other cases.²⁶³

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ *Id.*

²⁶⁰ *Id.* (quoting one attorney for Dorigol as saying "educating an already 'highly educated' panel about financial derivatives will be much easier than educating a lay jury").

²⁶¹ See *Lehman Brothers Files Motion to Compel Arbitration in \$6.6M Dispute*, 5 BANK & LENDER LIAB. LITIG. REP., Jan. 19, 2000, at 3.

²⁶² *Banco Disa S.A. v. Lehman Brothers Inc.*, No. 99 Civ. 9487 (S.D.N.Y. 1999). The suit contended that Lehman knew the portfolio was risky and unsuitable, but pressed the risky strategy in order to make commissions and fees. See *\$6.6M Dispute*, *supra* note 261, at 3.

²⁶³ In 1998, several investment banks paid very large settlements to settle suits related to Orange County's 1994 bankruptcy. Merrill Lynch paid \$400 million, the fifth-largest settlement in Wall Street history; Morgan Stanley paid \$69.6 million; and CS First Boston paid \$52.5 million. See *Credit Suisse First Boston Settles Orange County Suit for \$52.5 Million*, 30 SEC. REG. & L. REP. (BNA) 748 (May 15,

To the extent the motivations were to avoid large settlements encouraged by the unpredictability of a jury verdict, the role of arbitration in derivatives disputes might become more substantial over time, as it has in other areas.²⁶⁴

4. A PROPOSAL FOR "SYNTHETIC COMMON LAW"

Parties to derivatives transactions could eliminate much of the uncertainty surrounding such transactions by agreeing *ex ante* to have a set of hypothetical cases (i.e., "synthetic common law") govern any future disputes. This Section explains the arguments in favor of synthetic common law and suggests a few synthetic cases for parties to use.²⁶⁵

4.1. How Synthetic Common Law Could Govern Disputes

In a synthetic common law system, private law generating associations would publish menus of cases and commit to resolve disputes based on those cases. These would be for-profit associations, established with a view to earning income both by providing legal rules *ex ante* and by adjudicating disputes *ex post*. The associations would likely consist of experts in individual fields of law, perhaps including law professors.

These associations would publish menus of cases. The cases would involve simplified facts in particular areas of practice and would focus on the issues that, in the judgment of the association

1998); PARTNOY, F.I.A.S.C.O., *supra* note 105, at 268. In agreeing to settle these claims, CS First Boston's CEO, Allen Wheat, noted that "given the magnitude of the County's losses and the fact that litigation is unpredictable and distracting for any firm, this settlement is the right course of action." *Credit Suisse, supra*, at 748. Similarly, Bear Stearns & Co. paid \$39 million to settle a suit brought by three bankrupt hedge funds alleging fraud in the sale of collateralized mortgage obligations known as "toxic waste." *Bear Stearns Settles Granite Partners "Toxic Waste" CMO Suit for \$39M*, DERIVATIVES LITIG. REP., Jan. 24, 2000, at 4. The losses, totaling \$225 million, were incurred following the Federal Reserve Board's increase in interest rates in 1994. *Id.*

²⁶⁴ See *supra* Section 3.4.

²⁶⁵ I am including the synthetic cases for illustrative purposes only, and I would defer to the choices of current derivatives market participants (and their lawyers) to determine whether particular cases satisfy the expectations of the parties to a particular contract. In fact, it is precisely such deference to the market—based on the assumption that private parties will choose the cases that most efficiently and fairly would govern any dispute—that is critical to the success of a synthetic common law regime.

(and of parties who would choose that association), would most likely arise in future disputes. The cases could include published state and federal cases, or examples based on such cases, or even stylized versions of such cases with certain facts changed or omitted.

Private parties then would select from among these competing associations a particular menu of cases to govern their contracts. Numerous associations would compete for a particular contract. Private parties could simply list, or check a box for, cases they selected as the governing body of legal rules for a particular contract.

The association would then commit to resolve disputes based on those cases and would in fact adjudicate any such disputes. The association might describe, or even commit to, its anticipated mode or process of reasoning in any future dispute.²⁶⁶ The reputation of the association over time would be based on its ability to keep its commitments. The association could incorporate information gleaned from actual cases it adjudicated into new hypothetical cases for future parties to choose. Associations would compete for business over time. As with arbitration, courts would have limited review of association judgments.²⁶⁷ In effect, the association's selected cases would become the body of relevant legal rules.

From the perspective of private parties, a blended system would be no more complex *ex ante* than arbitration. Parties would simply select an association to adjudicate their disputes and then select from that association's menu of cases a particular set of cases to govern their contract. The association would adjudicate any disputes based on the selected menu of cases and the selected mode of legal reasoning, if applicable.

Parties could select or modify already-decided cases to include as part of a contract. For example, parties might include *Procter & Gamble Co. v. Bankers Trust Co.*,²⁶⁸ but eliminate Judge Feikens's sweeping statement about duties and obligations in swap transactions. Alternatively, parties might adopt the facts of the case but have the judge in the case refuse to grant summary judgment in favor of BT, perhaps noting that a fiduciary relationship existed.

²⁶⁶ Parties might also specify *ex ante* the cost or rate structure for adjudication and might list acceptable adjudicators.

²⁶⁷ See *supra* note 120.

²⁶⁸ See *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996).

Similarly, parties might adopt the facts of the SEITA case,²⁶⁹ but reverse the outcome, or incorporate *Press, Independent Foresters*, and *Kwiatkowski II* into a single, sensible decision.²⁷⁰

In addition, parties could create new cases to govern future disputes. The following cases are meant to be illustrative, not comprehensive, and indicate the types of issues that parties might decide to address in individual cases. In addition, parties could specify how important certain facts were to the decision in the case or what type of reasoning they would like an adjudicator to use if the facts do not match the facts of the case.

First, the regime could reduce uncertainty associated with differential statutory coverage of derivatives.²⁷¹ The parties would make it clear that federal securities and commodities statutes do not govern their disputes. For example, the menu of cases could include the following illustrative case:

Case No. 1: Party A and Party B enter into the derivative transaction described in the attached term sheet.²⁷² Party B loses money and sues in federal court, claiming the federal securities laws should govern the dispute because a derivative is a "security."²⁷³ Held: the derivative instrument is not a security.

Note that the above case depends on the acquiescence of the federal courts. When Party B filed suit, the judge drawing the case would need to recognize the party's prior agreement to resolve all disputes through the synthetic common law regime and dismiss the claim. Notwithstanding the Supreme Court's statement that such dismissal is warranted based on the parties' prior agreement,²⁷⁴ there is some risk that a judge would refuse to dismiss the

²⁶⁹ See *Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Bros. Int'l Ltd.*, No. 113154/96, 1998 N.Y. Misc. LEXIS 219 (N.Y. Sup. Ct. Feb. 9, 1998).

²⁷⁰ See discussion *supra* notes 147-172 and accompanying text.

²⁷¹ This uncertainty is described in detail *supra* Section 3.1.

²⁷² The parties would simply attach or incorporate by reference a copy of the term sheet for their transaction, once the terms are finalized.

²⁷³ The parties could include a similar case excluding the applicability of the commodities laws as well.

²⁷⁴ The Supreme Court has endorsed the notion of two contracting parties in different jurisdictions specifying *ex ante* the law to be applied to their contractual

claim. In such an event, the parties would bear the litigation costs associated with an appeal and the litigation risk of a change in Supreme Court position. However, this same problem is present for arbitration generally and does not appear to be serious. In any event, the costs would be lower than the costs of litigating a federal claim, which neither party believed *ex ante* would govern any future dispute.

Second, synthetic cases could reduce the uncertainty associated with ambiguous common law decisions. For example, consider the case law dealing with lack of authority claims.²⁷⁵ To the extent parties are concerned, as they seem to be, that one party could avoid its obligations on a derivatives contract simply by refusing to pay any losses, the parties could include a case holding that refusal to pay would be a breach of the derivatives contract, entitling the non-breaching party to damages under the regime:

Case No. 2: Party A and Party B enter into the derivative transaction described in the attached term sheet. Party B provides evidence that the transaction is both legal and authorized.²⁷⁶ Party B loses money and is in "default"²⁷⁷ on the transaction. Party B claims the contract is illegal and unenforceable. Held: unless another case in this menu establishes otherwise,²⁷⁸ Party A is entitled to payment from Party B of the amount owed.

relationship. See *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 516 (1974) (stating that where the governing law is unclear "[a] contractual provision specifying in advance the forum in which disputes shall be litigated and the law to be applied is, therefore, an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction.").

²⁷⁵ See *supra* notes 208-227 and accompanying text.

²⁷⁶ Such evidence might include the signed authorization of the board of directors or particular managers, applicable powers of attorney, or even a video or audiotape of a conversation in which the purchaser authorized approval of the transaction.

²⁷⁷ Events of default are specified in great detail in the standard form ISDA agreement already used by derivatives counterparties. Accordingly, the parties could simply make reference to that agreement and incorporate the definitions by reference.

²⁷⁸ For example, another case might hold that if Party A defrauded Party B, then Party B would not be liable.

Including such a case in a derivatives contract might resolve the problem of authority in a way statutes or cases could not. Recall the problem associated with the Indonesian statute requiring board approval, notwithstanding the fact that it often is impracticable to obtain such approval. An Indonesian statute could specify when a contract will be binding on an Indonesian company even without the board of commissioner's approval. Alternatively, Indonesian courts could hear and resolve cases, preferably by reported opinion, in a way that would provide guidance to future parties. However, neither resolution by statute nor common law seems likely, given the dearth of finance-related legislation and cases. Nor does it seem probable that a treaty or executive agreement between Indonesia and another country would allow parties to choose another, clearer legal regime, with the knowledge that they would be able to collect and enforce a judgment.

A synthetic common law regime could specify what types of contracts would require the board of commissioner's approval and give plenty of examples, based on easy-to-discern variables, such as notional amount, value-at-risk, and scenario analysis, as functions of revenue, net income, or some other accounting variables. The parties to the contract could choose the regime that most closely corresponds to their expectation of which transactions would be authorized. Unauthorized transactions would be unenforceable, although such transactions still might occur with adequate collateral. As an alternative, or perhaps additional, synthetic case, consider the following:

Case No. 3: Party A and Party B enter into derivative transactions with a notional value in aggregate of \$100 million or less. Party B is an Indonesian company and therefore normally must obtain the approval of its board of commissioners for any derivative transactions. Party B loses money on the derivative transaction described in the attached term sheet and fails to pay Party A. Party B's board of commissioners did not approve the transaction. Held: the transaction was deemed approved because Party A and Party B had entered into derivative transactions with notional value of \$100 million or less, and Party A therefore is entitled to payment from Party B of the amount owed.

Similar problems arise when the purchaser of derivatives attempts to renege by claiming one of its employees (a "rogue trader") engaged in unauthorized trading in those instruments. This issue has arisen in numerous cases, including disputes between two Chinese companies and Lehman Brothers Inc.,²⁷⁹ between Sumitomo Corp. and several large banks,²⁸⁰ and between a Malaysian company and Credit Suisse.²⁸¹ Many of these suits were filed under non-U.S. legal regimes that do not recognize the common law doctrine of apparent authority. As a result, derivatives sellers need to assure themselves before a transaction occurs that the agent for the purchaser has actual authority.

A synthetic common law regime would enable the parties to specify in advance what facts would constitute apparent authority. For example, the synthetic cases might find that there was authority when an employee with the title "managing director" (or some similar title) signs a derivatives contract, representing that she has authority to act on behalf of the purchaser. Or the case might say that it is not enough to rely on only one signature; two or three are required. Or the case might require board approval for each transaction. In any event, the parties in advance could choose the law that best fits their situation. Significantly, the fact that parties en-

²⁷⁹ The suits occurred after China International United Petroleum & Chemicals and China National Metals and Minerals Import & Export Corp. refused to pay amounts owed to Lehman on various foreign exchange and interest rate derivatives transactions. Each Chinese firm claimed the trades were unauthorized because the employees who signed the contracts did not have the necessary corporate authority. The argument was simple: if the trades were unauthorized, they were unenforceable. In each case, Lehman filed suit in the Southern District of New York for breach of contract. See Victor L. Hou, *Derivatives and Dialectics: The Evolution of the Chinese Futures Market*, 72 N.Y.U. L. REV. 175, 187 (1997).

²⁸⁰ Sumitomo sued Union Bank of Switzerland (in Tokyo District Court) and Chase Manhattan Bank (in the Southern District of New York) claiming that the banks had made unauthorized loans to Sumitomo's head copper trader who had engaged in unauthorized copper trading, sustaining losses of \$2.6 billion. Sumitomo alleged not only that the banks knew that the trader was not authorized to take out loans, but that the banks had disguised the loans as derivative swap transactions to help hide the unauthorized trading. See Bennett & Marin, *supra* note 13, at 32-33.

²⁸¹ Malaysian conglomerate Berjaya Group lost \$14 million on a derivatives transaction between Credit Suisse and Berjaya's Cayman Islands' subsidiary, and sued in Malaysia High Court, claiming the transaction was unauthorized because the Berjaya director who entered into the transaction had not obtained the required approvals. See Stephen Duthie, *Berjaya Group Files Suit Over Interest-Rate Swap*, ASIAN WALL ST. J., Mar. 7, 1995, at 3.

gaged in deliberations about the choice of synthetic law would be strong evidence that they considered the authority issue in advance and that the transaction would be either authorized or not, if the facts fit one of the hypothetical synthetic cases.

As to other common law claims, the parties could include cases related to duty-based claims (i.e., breach of fiduciary duty or negligent misrepresentation), describing several relationships and then concluding for each whether a particular duty existed. Then, if the parties' relationship changed over time, a duty might or might not be triggered. The parties could do the same for fraud-related claims. Cases might specify what type of misrepresentation would be actionable. Consider the following case:

Case No. 4: Party A and Party B enter into the derivative transaction described in the attached term sheet. Party A sends to Party B the attached scenario analysis.²⁸² Party B loses materially²⁸³ more money on the derivative than the scenario analysis

²⁸² A scenario analysis indicates how a particular instrument is expected to perform, given changes in one or more variables. Typically, scenario analysis is provided by the more sophisticated derivative seller (e.g., Party A) to the less sophisticated derivative buyer (e.g., Party B). For example, consider a derivative contract that paid Party B \$10 million $\times$ (JPY/USD - 100)/100 minus \$10 million, where JPY/USD is the Japanese Yen to U.S. Dollar exchange rate at the maturity of the contract. A scenario analysis might resemble the following:

<u>JPY/USD</u>	<u>Payment Owed To (From) Party B</u>
120	\$2 million
110	\$1 million
100	\$0 million
90	(\$1 million)
80	(\$2 million)

If the numbers in the "Gain (Loss) to Party B" column were materially inaccurate, Party A would not be entitled to payment from Party B of any amount owed. For example, if the term materially was defined to be a deviation of more than one percent, and the scenario analysis indicated that if JPY/USD = 80, the Payment Owed To (From) Party B would be (\$1 million) when the actual expected amount owed was double that amount, then Party A would not be entitled to payment of the \$2 million owed to Party A by Party B.

²⁸³ Materially could be defined to be more than a certain percentage above the amount of losses indicated in the scenario analysis. If the payoff from the derivative security was linear, the exact amount of loss implied by the scenario analysis could be calculated simply using linear interpolation. If the payoff from the derivative security was non-linear, the exact amount of loss implied by the scenario analysis could be calculated by Party A, with review by the adjudicator and/or appointed experts.

had indicated Party B would lose. Held: Party A is not entitled to payment from Party B of any amount owed, and Party B is entitled to payment from Party A of any amount owed.

A series of similar cases could define the parameters of the actionable misstatements and thereby define precisely the parameters of any disclaimer statements included in the contracts.²⁸⁴ The cases would provide a guidepost indicating what sort of behavior would constitute reasonable reliance by the purchaser.

Descriptions of cases in an ISDA Master Agreement might even cover which contracts would fall under anti-gambling statutes.²⁸⁵ For example, synthetic cases involving direct bets on a single economic variable (i.e., interest rates, foreign exchange, stock prices) would be enforceable, whereas cases involving complex bets on multiple economic variables that could have been made more simply, or that involve non-economic variables (e.g., bets on a sporting event), would be unenforceable.

Finally, a synthetic common law regime could incorporate whatever aspects of private law and private adjudication the parties found to be of value. Nothing in the regime would prohibit parties from signing a detailed ISDA agreement or from specifying additional provisions in the form of private law contractual language. Neither would the regime prohibit the use of already established arbitration or mediation regimes, to the extent they were to accept the methodology of reasoning by analogy to synthetic cases. Synthetic common law simply adds another arrow or two to the quiver.

4.2. Institutional Barriers to Synthetic Common Law

What are the barriers to parties implementing a synthetic common law regime today? There are several. First, there is no evidence private parties have actively considered the idea; it may be the case that no private party has thought to consider such a regime, or that a few parties have considered it, but they either did not implement the regime or did not publicize their implementation.

²⁸⁴ See *supra* notes 245-252 and accompanying text.

²⁸⁵ See *supra* notes 98-106 and accompanying text.

Second, arbitrators and arbitration systems might benefit from uncertainty about future decisions. Arbitration regimes appear to have a degree of market power²⁸⁶ and might benefit if their legal rules and conclusions remain both secret and indeterminate.²⁸⁷ Synthetic common law would turn arbitration into a much more commodity-like product than it currently is.

Third, the prohibition of judicial advisory opinions²⁸⁸ prevents courts from using synthetic common law and might lead some courts to balk at enforcing awards if the decision used advisory opinions. The synthetic cases could be considered advisory opinions, although it is arguable they are simply an expression of the intent of the parties, in case form. Of course, if a federal district court were *directly* to implement a synthetic common law regime, it almost certainly would be reversed. But there is little reason to believe a court's reliance on such a system, especially given the limited standards of review of arbitration judgments, would trigger much appellate court scrutiny.

Fourth, it is possible that there is market failure in the market for competitive adjudication firms. There is some evidence that the market for arbitration does not work particularly well, and there are structural reasons contributing to ineffective competition among adjudicators. Judge Richard Posner has considered and rejected the notion that a competitive industry might evolve in which adjudicators competed for business, although he seems to have assumed such competition could occur only on an *ex post* basis.²⁸⁹

²⁸⁶ There are reasons to believe arbitration may be the sort of business that leads to oligopoly: there are economies of scale associated with arbitration, arbitration may be a natural monopoly, and there may be a path dependence story in which particular regimes are chosen first and then persist. In any event, there are only a few arbitration regimes, the market is highly concentrated, and there has been very little entry into or change in structure of the arbitration industry.

²⁸⁷ Cf. Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927-28 (1998) (making the same indeterminacy argument for Delaware corporate law).

²⁸⁸ See HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 65-67 (Paul M. Bator et al. eds., 3d ed. 1988). Some state courts do not have a constitutional prohibition against advisory opinions. See Barry Latzer, *Whose Federalism? Or, Why "Conservative" States Should Develop Their State Constitutional Law*, 61 ALB. L. REV. 1399, 1413 n.56 (1998) (noting that "some state courts, unlike the Supreme Court, have no prohibition against advisory opinions.").

²⁸⁹ "Hiring competitive judicial firms is not the answer either, quite apart from the difficulty of maintaining consistency of legal decisions. Competition doesn't work well when customers cannot determine even roughly the quality of the out-

Posner appears not to have considered the possibility of dispute resolution firms competing on an *ex ante* basis, as private synthetic common law services would. In such a competitive environment, private parties could easily assess the quality of firms, as well as the menu of already decided cases. Private parties considering competing firms could examine the cases offered, read any additional decisions by the firms, examine other representations as to process or mode of reasoning, and then—after any dispute—compare the result with prior cases and representations. Firms whose decisions did not match the agreed upon cases would not exist for long, because they would acquire a reputation for such decisions, and private parties would not choose them. By writing clear opinions in the cases it adjudicated, a firm could obtain a competitive advantage over firms not offering such opinions. For example, parties clearly are able to obtain sufficient information to enable them to choose which judge in a particular district they would like to govern their dispute; in fact, the selection of a particular judge typically drives the parties' litigation strategies.²⁹⁰

Fifth, private law typically has been generated by sophisticated parties, who benefit from the use of uniform contract terms when contracting with less sophisticated parties. A few investment banks, and primarily a single law firm, developed the standard form ISDA contracts used in the derivatives area, and an unsophisticated party is at a great disadvantage when negotiating over such documents with an investment bank's lawyers. As a result, many of the ambiguities and omissions in these contracts may be intentional on the part of the investment bank but unanticipated or unknown on the part of the less sophisticated counterparty. Synthetic common law might not generate as serious an information asymmetry problem as private law ISDA provisions, because a description of the results in particular cases would be more obvious, even to an unsophisticated counterparty. Suppose a sophisticated party selects synthetic cases that are unfavorable to the unsophisticated party; at least in this instance, the unsophisticated party would be able to (and likely would want to) read the cases and

put offered by the competing firms and when warranties or equivalent guarantees are infeasible." RICHARD A. POSNER, *OVERCOMING LAW* 115 (1995).

²⁹⁰ A recent example of this was the initial selection of Judge Thomas Penfield Jackson to adjudicate the antitrust suit by the U.S. Department of Justice against Microsoft.

might even recognize an unfavorable result. In contrast, an unsophisticated party presented with a long, standard-form contract written in broad, general terms is less likely to read the contract and even less likely to understand it. As noted earlier, particular contract terms are unlikely to be priced, given the structure of the derivatives market. If synthetic common law would impose costs on the more sophisticated party to an established contractual arrangement, that party naturally would oppose the regime.

5. CONCLUSION

In this article, I have analyzed the various approaches to regulating the global market for financial derivatives. The contours of statutory, judicial, private, and arbitral approaches to regulation are constantly shifting.

One consistent theme has been the importance of certainty.²⁹¹ In every area of derivatives regulation certainty is paramount, yet is often lacking. In the rapidly evolving markets for complex financial instruments, it is increasingly difficult for either public or private entities to specify useful legal rules *ex ante*. In addition, as the cost of resolving disputes in these markets increases, it is more difficult for judges or arbitrators to resolve disputes in a fair and efficient manner *ex post*.

In this article, I have suggested one way parties transacting in derivatives markets might use synthetic common law to resolve uncertainty in their relationships. A synthetic common law regime might capture the *ex ante* advantages associated with statutes while preserving the flexibility associated with *ex post* adjudication.

As our society shifts to more synthesized experiences and virtual realities, it is tempting to stick by what is authentic and real. Real statutes and common law will always have a place in modern society, just as some people always will prefer organic food, natural fur clothing, antediluvian housing, and interacting with human

²⁹¹ It is difficult to overstate the importance of certainty to the derivatives markets. Following the uncertainty associated with unwinding transactions involving Long-Term Capital Management in August and September 1998, the volume of derivatives trading dropped markedly. The Bank for International Settlements said the "most striking development" in the derivatives market during the first half of 1999 was the sharp decline in foreign exchange contracts, a decline that began during the second half of 1998. See *Global Derivatives Statistics*, *supra* note 49, at 6.

beings rather than computers. But in some segments of society, the cost of holding fast to reality based on subjective or uncertain belief is too great. Derivatives market participants frequently trade in synthetic assets, in part because trading in the real underlying assets (e.g., stocks or bonds) is no longer practicable or cost effective. Perhaps, the same is true of legal rules. If so, it is time to consider abandoning the reality of law.

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