# DERIVATIVES DISCLOSURE REQUIREMENTS: HERE WE GO AGAIN

| I.  | Introduction                                        | 441 |
|-----|-----------------------------------------------------|-----|
| П.  | Derivatives: Definition and History                 | 443 |
|     | A. Forwards                                         | 444 |
|     | B. Futures                                          | 444 |
|     | C. Options                                          | 445 |
|     | D. Swaps                                            | 445 |
| Ш.  | Proposed Legislation and Regulation                 | 447 |
|     | A. Suitability Requirements                         | 448 |
|     | B. Supervision of Management                        | 448 |
|     | C. Knowledgeable Board of Directors                 | 449 |
|     | D. Disclosure Standards                             | 451 |
| IV. | SEC Proposals                                       | 452 |
| V.  | Case Studies: Would the Proposed Legislation Have   |     |
|     | Made a Difference?                                  | 453 |
|     | A. Derivatives Trading at Bankers Trust             | 453 |
|     | 1. BT Securities and Gibson Greetings               | 454 |
|     | 2. BT Securities and Procter & Gamble               | 456 |
|     | B. Orange County Bankruptcy—A Fate Decided by       |     |
|     | Voters, Not a Lack of Regulation                    | 458 |
|     | C. Internal Controls and the Lessons of Barings PLC | 460 |
| VI. | Conclusion                                          | 462 |
|     |                                                     |     |

#### I. INTRODUCTION

In the 1980s, "junk bonds"<sup>1</sup> were the curse of Wall Street. The villains of the 1990s are financial derivatives. Congressman James A. Leach dubbed derivatives the "wild card" in international finance,<sup>2</sup> while a Citicorp executive labeled derivatives as the "basic banking business of the 1990s."<sup>3</sup> In fact, "[i]n all the history of financial markets, no markets have ever grown or evolved as rapidly as have the derivative markets."<sup>4</sup>

<sup>&</sup>lt;sup>1</sup> Junk bonds are bonds paying an above average interest rate to make up for their below than average rating. A lower than average rating reflects the possibility that the obligations under the bond may not be met by the issuer. See RICHARD SAUL WURMAN ET AL., THE WALL STREET JOURNAL GUIDE TO UNDERSTANDING MONEY AND MARKETS 52 (1990) [hereinafter WSJ GUIDE].

<sup>&</sup>lt;sup>2</sup> Carol J. Loomis, The Risk That Won't Go Away, FORTUNE, Mar. 7, 1994, at 42.

<sup>&</sup>lt;sup>3</sup> Id. at 40.

<sup>&</sup>lt;sup>4</sup> John F. Marshall & M.E. Ellis, Investment Banking and Brokerage 227 (1994).

On its face, the threat posed by derivatives seems only to affect large financial institutions. However, smaller banks, industrial companies, insurers, pension funds, and municipalities are also at risk.<sup>5</sup> Lively debate in recent legal literature runs the gamut. Current proposals in legal literature include: (1) no regulation at all; (2) a fine tuning of the current regulatory framework; (3) less regulation for the sale of derivatives to large sophisticated firms than for other users of these financial instruments; (4) congressional suitability requirements; and (5) enhancing the ability of the Commodities Futures Trading Commission (CFTC) to exempt derivatives from regulation.<sup>6</sup> Especially in light of proposed regulations from the Securities & Exchange Commission (SEC), the issue of derivatives regulation needs to be reexamined.

Following the collapse of Barings PLC (hereinafter "Barings"), the Orange County bankruptcy, and the Bankers Trust fiascoes which adversely affected Gibson Greetings (hereinafter "Gibson") and Procter & Gamble (hereinafter "P&G"), government regulators saw these securities as their new prey. Yet government regulators gave little attention to derivatives when institutions realized profits. It was only after derivatives contributed to financial crises that government regulators really scrutinized derivatives trading. An editor of a leading derivatives journal stated, "[t]he result is uniformed cries for the elimination of all derivatives from portfolios ranging from pensions to university endowments."<sup>7</sup>

In addition, the United States General Accounting Office (GAO) has stated that "U.S. regulatory gaps and weaknesses must be addressed, especially considering the rapid growth in derivatives activity."<sup>8</sup> If derivative financial instruments have become a bad dream for a few end users,<sup>9</sup> federal regulation as proposed would be an unnecessary nightmare.

This Note will introduce derivatives, outline congressional and SEC regulatory proposals, and demonstrate how many of the supposedly

<sup>&</sup>lt;sup>5</sup> Loomis, *supra* note 2, at 42-43.

<sup>&</sup>lt;sup>6</sup> E.g., Saul S. Cohen, The Challenge of Derivatives, 63 FORDHAM L. REV. 1993 (1995); Eric D. Roiter, Investment Companies' Use of OTC Derivatives: Does the Existing Regulatory Regime Work? 1 STAN. J.L. BUS. & FIN. 271; Geoffrey B. Goldman, Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed?" 95 COLUM. L. REV. 1112 (1995); Jennifer A. Frederick, Note, Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market, 64 FORDHAM L. REV. 97 (1995); William P. Albrecht, Regulation of the Exchange-Traded and OTC Derivatives: The Need for a Comparative Institution Approach, 21 J. CORP. L. 111 (1995).

<sup>&</sup>lt;sup>7</sup> Todd E. Petzel, Introduction to 1 DERIVATIVES Q., Summer 1995, at 1.

<sup>&</sup>lt;sup>8</sup> GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PRO-TECT THE FINANCIAL SYSTEM 126 (1994) [hereinafter GAO Report].

<sup>&</sup>lt;sup>9</sup> End users are the parties using derivatives, such as swaps, to hedge the positions they have taken in a security. Raj E.S. Venkatesh et al., *Introduction to Interest Rate Swaps, in* THE HANDBOOK OF DERIVATIVE FINANCIAL INSTRUMENTS 141 (Atuso Konishi & Ravi E. Dattatreya eds., 1991).

needed regulations are already in place or have been adopted by the many entities targeted by regulators. Furthermore, this Note will argue that possible future requirements are misguided. Legislation and regulation would not necessarily avoid any of the past failures, nor would they prevent any in the future. For example, rather than blaming the instrument, regulators should fault inept management, which investors can hold accountable through private causes of action. Additionally, although the regulations would mandate disclosure of derivative trading information, market forces already encourage companies to provide this information to their investors.

Part II defines a derivative and gives examples of the types of derivatives available on the open market. Part III introduces proposed legislation and discusses SEC financial statement disclosure releases. Specifically, by examining past legislation, this paper will demonstrate why proposed requirements are misguided. Part IV discusses the SEC's proposed disclosure requirements. Part V introduces notorious derivatives transactions, such as the Bankers Trust relationship with Gibson and P & G; the bank uptcy of Orange County; and the collapse of Barings. These disasters and their outcomes buttress the thesis that strict regulations are already in place, since wrongdoers in these cases suffered severe penalties for fraud. Part VI concludes by arguing that regulators should leave derivatives alone because institutional safeguards already exist.

Although derivatives trading can result in great losses, great gains are also possible. Increased regulation is in many aspects superfluous in light of currently available remedies. In fact, the International Swaps and Derivatives Association (ISDA) has stated that the current regulatory framework can meet the goals shared by all interested parties.<sup>10</sup> Increased regulation is likely to stifle the useful function of derivatives in hedging against the very risks posed by financial markets.

### II. DERIVATIVES: DEFINITION AND HISTORY

A derivative is a security whose value depends in some way upon the values of other more basic underlying securities.<sup>11</sup> Derivative financial instruments have been used for some time despite receiving much attention only lately. In the United States, municipal financiers in Massachusetts and later in the Confederate States initially developed deriva-

<sup>&</sup>lt;sup>10</sup> Lynn Stevens Hume, Legislation Needed for Derivatives, Group Says, The BOND BUYER, April 15, 1994, Markets at 2.

<sup>&</sup>lt;sup>11</sup> Atsuo Konishi & Ravi E. Dattatreya, *Introduction, in* The HANDBOOK OF DERIVATIVE FINANCIAL INSTRUMENTS 1 (Atuso Konishi & Ravi E. Dattatreya eds., 1991).

tives.<sup>12</sup> Today, market participants use derivatives to raise capital, hedge market disclosure, enhance income, and reallocate investment portfolios.<sup>13</sup> Proposed regulation has focused on four major types of derivatives as outlined by the GAO:<sup>14</sup> forwards, futures, options, and swaps.<sup>15</sup>

#### A. Forwards

When two parties enter a forward, they agree that that the holder must buy or sell a specified amount of an asset or index at a specified price on a specified date.<sup>16</sup> For example, if you enter into an agreement to purchase a new Land Rover from a British dealership in six months at a price of £50,000 (roughly \$75,000) you may not have that dollar amount now but know that you will earn it in six months' time. A possible concern is that the U.S. Dollar will lose its value, and the Land Rover will cost you more than \$75,000. To protect yourself against such an event, you may enter into a contract with another party to secure an exchange rate for that future purpose. The other party to the agreement may think that the U.S. Dollar will increase in value and that in six months' time that \$75,000 will be worth more than £50,000. The other party to the transaction is assuming the risk of a devalued U.S. Dollar, and you will be guaranteed the price of \$75,000 for the Land Rover.<sup>17</sup>

#### B. FUTURES

Similar to forwards, futures also obligate the holder to buy or sell a specific amount or value at a specified price.<sup>18</sup> The difference between futures and forwards is that a futures contract is generally a standardized contract, not customized like a forward. For example, a brewery might need a certain amount of barley on a certain date to fulfill an order for beer. The brewery could enter a contract to secure delivery of barley on a specified date for a specified price. The other contracting party, the speculator, promises such delivery. Should the price of barley drop in six months, the speculator will profit because he can purchase the barley at a lower price and sell it to the brewery immediately for a higher price. Conversely, should the price of barley rise in six months, the speculator

<sup>&</sup>lt;sup>12</sup> See generally Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 1-18 (1994) for a more detailed history on derivatives.

<sup>&</sup>lt;sup>13</sup> Mark J.P. Anson, New Disclosure Regulations Proposed by the SEC, DERIVATIVES Q., Summer 1996, at 15.

<sup>14</sup> GAO REPORT, supra note 8, at 4.

<sup>&</sup>lt;sup>15</sup> For a detailed description of actual derivative financial transactions, see the discussion of derivatives trading at Bankers Trust in section V.A of this Note.

<sup>&</sup>lt;sup>16</sup> GAO REPORT, supra note 8, at 5.

<sup>&</sup>lt;sup>17</sup> See id. at 26 for a similar example.

<sup>&</sup>lt;sup>18</sup> WSJ GUIDE, supra note 1, at 77.

will lose money since he will have to purchase the barley for a higher price than what he can sell it for.<sup>19</sup> Such futures are traded worldwide on standardized exchanges in Chicago, London, Minneapolis, New York, Philadelphia, Sydney, Tokyo, and Zurich.

# C. Options

Call options grant the right to purchase, while put options grant the right to sell a specified quantity of a commodity or a financial asset at a specified price. Buying a call option allows the purchaser to acquire a security at a specified price.<sup>20</sup> Hence, if the call option holder has the option to buy a share of General Motors at \$50, and if the shares are trading at a price greater than \$50 on the New York Stock Exchange, then the option holder can make a profit. Conversely, if the option holder has a put option<sup>21</sup> at \$50 and the stock is selling below that price, the option holder can sell the stock at \$50 even if the price at which it trades on the market is lower.

# D. Swaps

Generally, swaps are agreements between counterparties to make payments to each other at various dates in the future. One widely used swap transaction is the currency swap, first developed in London in 1979.<sup>22</sup> In a currency swap, counterparties may desire each other's access to a certain foreign currency. An investment bank typically engineers a currency swap<sup>23</sup> by working out a transactional plan.

Assume that the car dealer of the Land Rover has a strong relationship with a British bank and can borrow £30,000 for five years at a rate of 8%, while a U.S. company can borrow \$70,000 for five years at a fixed rate of 7%. Assume further that the British manufacturer seeks to borrow \$70,000 for five years but is offered the rate of 10% by a U.S. bank, and that the U.S. company seeks to borrow £30,000 for five years, but is offered the rate of 11%. Naturally, the British manufacturer will want the \$70,000 loan offered to the U.S. company, and the U.S. company will want the British manufacturer's £30,000 loan.

<sup>&</sup>lt;sup>19</sup> For a similar example, see GAO REPORT, supra note 8, at 25.

 $<sup>^{20}</sup>$  Aswath DAMODARAN, DAMODARAN ON VALUATION 319 (1994). "A call option gives the buyer of the option the right to buy the underlying asset at a fixed price at any time prior to the expiration date of the option. The buyer pays a price for this right." *Id.* 

<sup>&</sup>lt;sup>21</sup> GAO REPORT, supra note 8, at 5. See also DAMODARAN, supra note 20, at 321. "A put option gives the buyer of the option the right to sell the underlying asset at a fixed price at any time prior to the expiration date of the option. The buyer pays a price for this right." Id.

<sup>22</sup> MARSHALL & ELLIS, supra note 4, at 228.

<sup>&</sup>lt;sup>23</sup> When acting in such capacity, the investment bank is typically referred to as the swap dealer.

These parties would be best off entering a currency swap. First, the British manufacturer would borrow  $\pm 30,000$  and exchange that notional value<sup>24</sup> with the \$70,000 borrowed by the U.S. company. Second, the parties would exchange those amounts with each other. Third, the parties would pay each other's interest rates. Finally, after the five years they will reexchange the loan principals, and each party will pay the amounts due to their respective banks.

A "swap effectively exchanges the cash flows that will occur in one financial transaction for those that will occur in another" financial transaction.<sup>25</sup> The great advantage of such swaps is that each party has gained access to a debt market which was otherwise denied. The British car manufacturer obtained the five year loan of \$70,000 at 7% in comparison to the rate of 10% it was offered by the bank. The U.S. company obtained a loan of £30,000 at a rate of 8% while at best having been offered a rate of 11% by British banks.

Shortly after the development of the currency swap, the interest rate swap developed in 1981.<sup>26</sup> An interest rate swap entails the exchange of interest payments. For example, suppose Bank A has an obligation to pay 8% interest a year whereas Bank B has an obligation to pay a rate dependent on the London Interbank Borrowing Rate (LIBOR).<sup>27</sup> If Bank A wishes to take its chances and pay the LIBOR rate and Bank B instead wishes to pay the fixed 8% rate, the banks may exchange payments such that Bank A would assume the interest rate of Bank B, and Bank B would assume the interest rate of Bank A. Banks A and B would then be counterparties.

Bank A ------Pays LIBOR Rate---->Bank B <-----Pays 8%------

Derivatives were historically used for hedging purposes to protect against changes in the value of an underlying security. This purpose has changed as speculators use derivatives to profit on the derivatives' changing values. Such speculation has led to increased volatility in the derivatives markets.<sup>28</sup> Derivatives are now used to obtain better financing terms, often through the use of currency swaps.<sup>29</sup> They also are a

<sup>&</sup>lt;sup>24</sup> The notional amount "is the amount that is used to determine the actual cash flows paid or received by applying the corresponding interest rates for the appropriate calendar periods." Venkatesh et al., *supra* note 9, at 135.

<sup>&</sup>lt;sup>25</sup> Ian Cooper, *Buddy Can You Swap a Dime?*, FIN. TIMES (London), February 9, 1996, at 12.

<sup>&</sup>lt;sup>26</sup> MARSHALL & ELLIS, *supra* note 4, at 228.

<sup>&</sup>lt;sup>27</sup> "LIBOR is the rate of interest charged on interbank loans of Eurocurrency deposits." *Id.* at 232.

<sup>28</sup> GAO REPORT, supra note 8, at 25.

<sup>29</sup> Id.

multitrillion dollar market<sup>30</sup> as they have become fixtures in thousands of corporate portfolios.<sup>31</sup> Users of derivatives include securities firms, insurance companies, and mutual funds.<sup>32</sup>

#### III. PROPOSED LEGISLATION & REGULATION<sup>33</sup>

The General Accounting Office believes that, in order to prevent a "financial shock" reminiscent of the 1987 stock market crash or the savings and loan crisis, there needs to be heightened regulation.<sup>34</sup> Since 98% of CEOs from the largest companies in the United States plan to increase or maintain their corporation's use of derivatives,<sup>35</sup> it is no surprise that the effects of derivatives failures have caught the attention of policy makers.

The House proposed the Derivatives Safety and Soundness Supervision Act of 1995 (H.R. 31) to oversee derivatives trading.<sup>36</sup> The Act, which never came to a vote, would have required that financial institutions engage in derivatives trading in a "safe and sound manner."<sup>37</sup> Another proposed requirement was that a "sufficient number" of the institution's directors be familiar with the risks of derivatives activities.<sup>38</sup>

In sponsoring H.R. 31, Congressman Henry B. Gonzalez referred to the derivatives trading losses in Orange County, as well as those suffered by Gibson Greetings in its derivatives transactions with BT Securities (hereinafter "BT"), the securities affiliate of Bankers Trust.<sup>39</sup> The Act would have regulated the use of "Derivative Financial Instruments"<sup>40</sup> by "Financial Institutions," defined broadly to include commercial banks,

<sup>35</sup> This figure is from a *Fortune* magazine poll. Terence P. Pare, *Learning To Live With Derivatives*, FORTUNE, July 25, 1994, at 108.

<sup>&</sup>lt;sup>30</sup> The 1994 worldwide total of all derivatives contracts was estimated to be approximately \$16 trillion. Loomis, *supra* note 2, at 43.

<sup>31</sup> Id. at 40.

<sup>&</sup>lt;sup>32</sup> Roger M. Zaitzeff, *Regulating Financial Derivatives*, NAT'L L.J., August 29, 1994, at B9-B10.

<sup>&</sup>lt;sup>33</sup> The proposed legislation and regulation discussed in this section of the Note occurred in the 104th Congress, but it was not passed. This Note critiques legislation considered in the 104th Congress on the assumption that future legislative proposals will embody past suggestions. See Joanne Morrison, Derivatives Industry Will Face Fight To Keep Regulations Away in 1997; New Derivatives Law May Be In Sight This Year, THE BOND BUYER, Jan. 3, 1997, at 1.

<sup>34</sup> GAO REPORT, supra note 8, at 3.

<sup>&</sup>lt;sup>36</sup> H.R. 31, 104th Cong. (1995). This bill is very similar to the bill introduced by Representative Gonzalez during the 103rd Congress. H.R. 4503, 103rd Cong. (1994).

<sup>37</sup> H.R. 31, 104th Cong. § 201(a)(1)(B) (1995).

<sup>&</sup>lt;sup>38</sup> Zaitzeff, supra note 32, at B10.

<sup>&</sup>lt;sup>39</sup> 141 CONG. REC. E35-02 (daily ed. Jan. 4, 1995) (statement of Rep. Gonzalez).

<sup>&</sup>lt;sup>40</sup> H.R. 31 defines Derivative Financial Instruments as "any qualified financial contract (as defined in § 11(e)(8)(D) of the Federal Deposit Insurance Act), and any other instrument, which the appropriate federal regulatory agency determines to be a derivative financial instrument." H.R. 31 § (2)(6) (1995).

savings banks, affiliates of banks, bank holding companies, their subsidiaries, and branches and agencies of foreign banks.<sup>41</sup> H.R. 31 would have required that the appropriate regulatory agencies work together to establish similar standards relating to capital, accounting, disclosure, risk management, and suitability for the supervision of financial institutions.<sup>42</sup> H.R. 31 merits further attention, as elements from the bill may be included in future proposals.

#### A. SUITABILITY REQUIREMENTS

A major concern of legislators is that a financial institution may suggest derivatives transactions which do not necessarily meet the fiscal objectives of its customers. H.R. 31 sought to remedy this:

> (H) Assurance that, consistent with safe and sound banking practices, a financial institution does not recommend or engage in derivatives activities which are inappropriate for a customer of the institution.<sup>43</sup>

Despite this seemingly simple solution, suitability requirements have been met with the same opposition as other provisions of the proposed regulations. SEC Chairman Arthur Levitt stated that there is no need for such regulation.<sup>44</sup>

In particular, industry leaders have questioned suitability requirements since they place the burden of bad investment decisions on financial institutions instead of on the investors who made the bad decisions.<sup>45</sup> Furthermore, Chairman of the Federal Reserve Alan Greenspan suggested that suitability requirements interfere with the notion that investors, sophisticated and unsophisticated, should bear the risk of their decisions.<sup>46</sup> While institutions are not now legally accountable as to suitability, reputations are certainly at stake.

#### B. SUPERVISION OF MANAGEMENT

Future legislation in the 105th Congress may require, as H.R. 31 did, that a corporation's board of directors closely scrutinize management's derivatives trading activities to ensure that the trading be com-

<sup>&</sup>lt;sup>41</sup> Id. § 2(6).

<sup>42</sup> *Id.* § 101(a).

 $<sup>^{43}</sup>$  Id.  $^{101(b)(1)(H)}$ . Suitability requirements are most important when the customer of the financial institution has limited knowledge of the risks associated with derivative instruments, such as when the broker of the derivative product does not provide enough disclosure to the investor, who may be an individual or a municipality.

<sup>44</sup> Zaitzeff, supra note 32, at B10.

<sup>&</sup>lt;sup>45</sup> The Daiwa Bank of Japan, 1995: Hearings of the Financial Institution and Consumer Credit Subcommittee of the Banking and Financial Services Committee, 104th Cong., 1 Sess. (1995) (statement of Alan Greenspan, Chairman of the Federal Reserve).

mensurate with the company's business strategy. H.R. 31 required the appropriate regulatory agencies to consider:

(I) Effective senior management supervision and oversight by the board of directors of a financial institution to ensure that the derivatives activity are conducted in a safe and sound matter and are consistent with the board of directors overall risk management philosophy and the institution's business strategy.<sup>47</sup>

While the regulators intended to insure that the board of directors serves its supervisory role, the regulators seem to expect shareholder apathy. In reality, if the passivity of the board results in great losses, concerned shareholders can vote for a new board. A properly functioning board should monitor management's activities to meet the duty of care standard already in place in state corporate law.<sup>48</sup>

Moreover, the current state of stock ownership partially obviates the need for monitoring as well. Institutional investors, such as mutual and pension funds, have a great stake in the current stock market,<sup>49</sup> compelling them to be active in a company's affairs. Individual shareholders, believed to make up this apathetic group, can now look to the behavior of these institutional investors as guidance. For instance, a mutual fund has a great deal at stake if it is heavily invested in a company. A mutual fund which is heavily invested in a particular company can exercise its influence in two ways: it can buy shares in a company which the mutual fund believes will prosper, or it can sell its shares in companies believed to conduct risky derivatives transactions. Individual shareholders are likely to follow suit.

C. KNOWLEDGEABLE BOARD OF DIRECTORS

Another theme of regulators is that a board of directors of a financial institution involved in derivatives activities must be informed of the risks associated with the derivatives activities of that institution, as well as the credit exposure of the institution with respect to such derivatives trading activities. H.R. 31 stated in part:

> (b) Requirement For Directors—No Financial Institution may act as a dealer in derivative financial instruments or as an active end user unless the Board of Directors of such institution is informed of the risk associated with the derivatives activities of the financial institution and

<sup>47</sup> H.R. 31 § 101(b)(1)(I) (1995).

<sup>&</sup>lt;sup>48</sup> Robert C. Clark, Corporate Law 125 (1986).

<sup>&</sup>lt;sup>49</sup> Ed McCarthy, Pension Funds Flex Shareholder Muscle, PENSION MGMT., January 1996, at 16.

the total current credit exposure of the institution with respect to any such activities. $^{50}$ 

The shareholders of a corporation elect the board of directors which then chooses management.<sup>51</sup> Under rules of corporate governance, the board must be aware of management's activities.<sup>52</sup> Such reliance on corporate governance is buttressed by the GAO study itself.<sup>53</sup> If the corporation suffers losses from derivatives trading, concerned shareholders might vote for another slate of directors who would be more likely to oversee derivatives trading.

Industry leaders have strongly opposed these suggestions, citing the availability of state corporate law remedies. The possibility of suing the Board of Directors may seem futile. Nevertheless, in *Brane v. Roth*,<sup>54</sup> the directors of the LaFontaine Grain Co-op were found to have violated the duty of care imposed by state corporate law<sup>55</sup> when they allowed the manager of the co-op to negligently use derivatives to hedge against falling grain prices. The co-op's accountant had warned that the co-op should have been trading against risk, and the board of directors ordered management to do so. Despite the manager's hedging \$20,050 of the co-op's \$7.3 million in grain sales, the court found that the board of directors had a duty to understand hedging techniques and should have monitored management more closely.<sup>56</sup>

This heightened duty of care standard will have the adverse effect of discouraging skilled individuals from serving on the board of directors of the very financial institutions targeted by this legislation.<sup>57</sup> The directors most knowledgeable about derivatives might fear they will be considered "uninformed" by overzealous regulators who will allege that the duty of care owed the corporation was violated.<sup>58</sup>

<sup>55</sup> The Court applied the duty of care standard defined in IND. CODE& 23-1-2-11 (1987). This statute has been repealed and replaced with IND. CODE& 23-1-35-1 (1995) which applies a less stringent duty of care standard.

56 ECONOMIST, Mar. 13, 1993, at 94.

<sup>57</sup> Hearing Before the House Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises: Committee on Banking and Financial Services, 104th Cong., 1 Sess. (1995) (testimony of Mark Lackritz, President, Securities Industry Association) [hereinafter Lackritz].

<sup>58</sup> Christopher L. Culp & Robert Mackay, *Regulating Derivatives*, 4 REGULATION 47 (1994).

<sup>&</sup>lt;sup>50</sup> H.R. 31 § 201(b) (1995).

<sup>5</sup>e CLARK, supra note 48, at 106.

<sup>52</sup> Id.

<sup>53</sup> GAO REPORT, supra note 8, at 45.

<sup>54 590</sup> N.E.2d 587 (Ind. Ct. App. 1992).

# D. DISCLOSURE STANDARDS

While H.R. 31's disclosure standards are excessive, they are the least of its evils. H.R. 31 amended the Federal Deposit Insurance Act to require that the appropriate federal banking agency demand the disclosure of information regarding derivatives. Much like the current SEC proposals discussed in the next section, H.R. 31 demanded that corporations disclose all information about derivatives, including the value at a fixed time of all derivative instruments, gains and losses from each type of derivative, and the credit exposure of the corporation for each class of derivatives when each derivative is about to expire. Legislators feel that enhanced disclosure would facilitate the decisions of voters during times when they are electing treasurers in municipalities and boards of directors in corporations. Derivatives dealers themselves agree with this call for improved disclosure requirements<sup>59</sup> as companies have taken it upon themselves to disclose derivatives activities in annual reports.<sup>60</sup> This allows blame to be placed on managers as it should be, and not on derivatives as financial instruments.<sup>61</sup>

Although proper corporate governance requires disclosure, according to market participants, H.R. 31 would have created inordinate reporting burdens.<sup>62</sup> In particular, market participants criticize the requirement of the disclosure of gross notional amounts<sup>63</sup> because this is not an accurate measure of value.<sup>64</sup> Futures, for instance, are highly leveraged derivatives requiring only a small purchase price as a percentage of their notional value. This translates into the possibility of earning or losing a great deal of money on a proportionally small investment. This is not a great problem for traders using futures for hedging purposes, since losses on the futures position can be offset by the gains in the underlying asset.<sup>65</sup> Nor does this present a great problem for speculators who essentially bet on future price movements. Also, requiring the disclosure of the net exposure with respect to each class of derivatives<sup>66</sup> does not accurately reflect the reduction in risk exposure when all derivative instruments are netted.<sup>67</sup> This is especially true when certain derivatives

<sup>&</sup>lt;sup>59</sup> See generally Lackritz, supra note 57.

<sup>&</sup>lt;sup>60</sup> See Anheuser-Busch Companies, Inc., 1995 Annual Report 67 (1996); Xerox Corporation, 1995 Annual Report 65 (1996).

<sup>&</sup>lt;sup>61</sup> Jonathan R. Macey, *Blame Managers, Not Derivatives*, NAT'L L. J., August 26, 1996, at A19.

<sup>62</sup> See generally Lackritz, supra note 57.

<sup>63</sup> H.R. 31 § 201 (1995).

<sup>64</sup> See generally Lackritz, supra note 57.

<sup>65</sup> Sheila C. Bair, Lessons From the Barings Collapse, 64 FORDHAM LAW REV. 1 (1995).

<sup>66</sup> H.R. 31 § 201(1995).

<sup>67</sup> See generally Lackritz, supra note 57.

contracts are entered into to reduce the effects of the risks posed by others.

#### IV. SEC PROPOSALS

While the future of legislation is unclear, the SEC has proposed its own disclosure requirements. "Financial Accounting Standard No. 119...requires disclosures" in financial statements concerning amounts, nature, and terms of derivatives not resulting in off-balance sheet losses.<sup>68</sup> The current confusion over disclosed information results from the different disclosure methods used.<sup>69</sup> The SEC is attempting to address these disclosure issues in the form of releases.<sup>70</sup> The releases suggest two additions: a qualitative disclosure to Regulation S-X<sup>71</sup> entitled Item 4.08(n), "General Notes to Financial Statements," and Item 305, a quantitative disclosure to Regulation S-K.<sup>72</sup>

Proposed Item 4.08(n) would enhance the disclosure of derivatives in three ways. Companies would have to provide clearer information on the choice of the accounting policy used to account for derivatives. Companies would have to reveal the impact of their hedging activities. 4.08(n) would also require companies to disclose the impact which derivatives have on their income, cash flow, and overall financial position.

To allow investors to examine the risk posed by derivatives, proposed Item 305(a) would require reporting companies to make quantitative disclosures through tabular presentation, sensitivity analysis, or value at risk. 305(b) would require the reporting of primary market risk exposures and the way in which they are managed.

Despite the fact that these proposed regulations would ensure disclosure, a Treasury Management Association survey revealed that 50% of those asked believed the proposals would not improve understanding of derivative instruments.<sup>73</sup> Furthermore, there is a greater cost to disclosure, especially where the proposed accounting standards are different

<sup>&</sup>lt;sup>68</sup> Anson, *supra* note 13, at 16.

<sup>69</sup> *Id.* at 19.

<sup>&</sup>lt;sup>70</sup> 61 Fed. Reg. 578 (1995) (to be codified at 17 C.F.R. pts. 210,228,229,239,240, 249) (proposed December 28, 1995), pursuant to 5 U.S.C.A. § 553(c). *See also* Alfred C. AMAN JR. & WILLIAM T. MAYTON, ADMINISTRATIVE LAW& 2.1.4 (1993).

<sup>&</sup>lt;sup>71</sup> Regulation S-X mandates the SEC's accounting rules for filings and audited financial statements which the Securities Acts of 1933 and 1934 require. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATIONE 9.4 (1996).

<sup>&</sup>lt;sup>72</sup> Regulation S-K addresses the way in which relevant information is presented. The Management Discussion and Analysis section is one of the most important parts of Regulation S-K. *Id.* § 3.3.

<sup>&</sup>lt;sup>73</sup> Suzanne McGee, Derivative Dealers Blast Rule Proposals, WALL ST. J., Sept. 26, 1996, at C16.

than the internal accounting standards used by targeted firms.<sup>74</sup> Moreover, this proposed mandatory disclosure scheme of derivative financial instruments may not necessarily benefit investors. The cost of the disclosure, which investors ultimately bear, might be greater than the value of having such information.<sup>75</sup>

One could argue that managers do not have an incentive to disclose information unless it is mandated. However, it is in management's best interests to disclose certain information, especially where investors discount for uncertainty. The less relevant the information which a company provides, the more the added cost of providing the information will be reflected in the share price.<sup>76</sup> In fact, companies have argued that financial markets are already demanding the same type of information that proposed legislation would mandate.<sup>77</sup> Essentially, the market does force companies to weigh the benefits of disclosure against the costs thereof.<sup>78</sup>

# V. CASE STUDIES: WOULD THE PROPOSED LEGISLATION HAVE MADE A DIFFERENCE?

In introducing legislation, officials often refer to specific events which they claim could have been avoided with the proposed legislation. Derivatives losses can be enormous, but causes of action are available which hold those actors who are in violation responsible. When the proposed legislation is applied to the Bankers Trust debacle, the Orange County bankruptcy, and the collapse of Barings, the legislation appears either unnecessary in light of internal controls which are currently being adopted, or superfluous when compared to laws and regulations already available.

# A. Derivatives Trading at Bankers Trust

The most publicized corporate losses due to derivatives include transactions between BT Securities (the securities affiliate of Bankers Trust) and two companies, Gibson and P&G. These financial disasters

<sup>&</sup>lt;sup>74</sup> Christopher L. Culp & Merton H. Miller, *The SEC's Costly Disclosure Rules*, WALL ST. J., June 25, 1996, at A14.

<sup>&</sup>lt;sup>75</sup> Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection* of *Investors*, 70 VA. L. REV. 669 (1984). Easterbrook and Fischel further this idea that not all information is worth its production cost by pointing out no one would suggest that investors benefit if "Chrysler 'disclosed' the contents of its corporate files, down to the purchase price of each conveyor belt and the details of its bargaining strategy for the next round of negotiations with employees." *Id.* at 695.

<sup>76</sup> Anson, supra note 13, at 23.

<sup>77</sup> McGee, supra note 73, at C16.

<sup>78</sup> Culp & Miller, supra note 74, at Al4.

have fueled much of the proposed legislation.<sup>79</sup> Nevertheless, BT Securities did not escape prosecution, which proved to some that actions for common-law fraud already provided adequate protection.<sup>80</sup> Moreover, those accountable for the debacle also faced the consequences of their irresponsibility, as one BT executive was fined for BT's derivatives trading.<sup>81</sup>

# 1. BT Securities and Gibson Greetings

Gibson began its derivatives exposure with BT on November 12, 1991. Gibson and BT entered into an interest rate swap, which Gibson hoped would reduce the interest expenses it was sustaining on a liability of \$50 million on which it was paying 9.33% interest.<sup>82</sup> The swap would have allowed Gibson a notional amount of \$30 million on which Gibson would pay BT a fixed rate of 5.91%. The fixed rate payments would begin on June 1, 1992 and continuing semi-annually until December 1, 1996, when Gibson would make the last payment. BT simultaneously would pay Gibson the 6-month LIBOR of \$30 million.

Gibson----5.91% of \$30 million-----> BT <---LIBOR of \$30 million-----

BT and Gibson entered into a second swap on a notional amount of \$30 million beginning on June 1, 1992. Gibson would pay BT the LI-BOR every six months, while BT would pay 7.12% of \$30 million to Gibson such that:

GIBSON-----LIBOR of \$30 million----->BT <----7.12% of \$30 million-----

In the first half of 1992, interest rates fell so that Gibson's payments to BT were less than the payments BT had to make to Gibson under the contract. BT and Gibson amended these derivatives in January 1992 and canceled them on July 7, 1992 with the net effect that BT paid Gibson \$260,000 as a settlement reflecting the decrease in interest rates.<sup>83</sup>

Remember, Gibson was concerned with its original \$50 million liability on which it paid 9.33%. Concerned that the market interest rate

<sup>&</sup>lt;sup>79</sup> When Congressman Gonzalez introduced The Derivatives Safety and Soundness Supervision Act of 1995, he directly referred to the SEC and CFTC orders forcing BT Securities to pay fines in connection with derivatives it sold. *See* 141 CONG. REC. E35-02 (daily ed. Jan. 4, 1995) (statement of Rep. Gonzalez).

<sup>&</sup>lt;sup>80</sup> Judge Feikens of Ohio's Southern District held that the common law fraud claim against BT could stand. *Swaps Defended*, WALL ST. J., May 17, 1996, at A14.

<sup>&</sup>lt;sup>81</sup> Laurie Hays, Ex-Bankers Trust Official is Fined in Derivatives Case, WALL ST. J., June 12, 1996, at C20.

 <sup>&</sup>lt;sup>82</sup> James Overdahl & Barry Schacter, Derivatives Regulation and Financial Management: Lessons from Gibson Greetings, FIN. MGMT., Spring 1995, at 68.
 <sup>83</sup> Id. at 69.

would be lower (for our purposes, LIBOR), Gibson would have preferred to pay the market rate. Taken in the aggregate, the first two swaps entered into with BT were a bet that the market interest rate would decrease.

Pleased with this result, Gibson entered into a ratio swap, akin to an interest rate swap in that Gibson's payments would have depended on a floating interest rate. The parties entered this ratio swap on October 1, 1992 to begin on April 5, 1993 and continue semi-annually on October 5 and again on April 5 of the following year. Until the termination date of October 5, 1997, BT was to pay Gibson a fixed rate of 5.50% of \$30 million while Gibson was to pay BT on the notional amount of \$30 million multiplied by LIBOR squared over 6%:<sup>84</sup>

GIBSON-----> BT <-----5.5% of \$30 million-----> BT

Note that Gibson's exposure to an increase in the LIBOR rate exponentially increases under this swap.

Neither of the above transactions continued until their scheduled maturities.<sup>85</sup> The ratio swap outlined above was canceled in exchange for BT paying \$978,000 and entering into another swap.<sup>86</sup> This process of canceling swaps and entering into new ones involved a "tear-up"<sup>87</sup> amount which projected the amount that would have been earned by one of the counterparties. Thus, if Gibson stood to make \$10,000 upon the natural termination of the swap, this amount would allegedly be factored into the newly entered swap.

When Gibson entered into these new swaps, it relied heavily on the valuation BT presented. Essentially, BT would value the existing swaps to determine the "tear up" value. Gibson's complaints centered around BT's valuation. Once Gibson began suffering staggering losses, it alleged that it had been misled by the financial modeling presented by BT.<sup>88</sup> Gibson claimed that BT owed Gibson a duty not to mislead.<sup>89</sup> Conversely, BT pointed out that the agreements entered into did not delineate any fiduciary duty.<sup>90</sup> BT argued further that the transactions were at arm's length and that the valuations presented were meant as contractual terms: conditions under which BT would enter into new swaps.

The SEC's own findings on this matter suggest that legal provisions are already in place. The SEC found BT violated of Section 17(a) of the

84 Id. at 76.
85 Id.
86 Id. at 70.
87 Id.
88 Id.
89 Id.
90 Id. at 70-71.

Securities Act,<sup>91</sup> Section 10(b) of the Exchange Act,<sup>92</sup> and Rule 10b-5 promulgated thereunder.<sup>93</sup> In particular, the conversation between a BT managing director and his supervisor evidenced fraud<sup>94</sup> under provisions already written into securities laws.

This dispute eventually ended in a settlement on November 23, 1994, in which BT forgave \$14 million of the \$20.2 million which Gibson owed.<sup>95</sup> The SEC and the CFTC<sup>96</sup> also brought actions. A BT broker faced charges which ended in a \$50,000 fine and a four-year ban from the securities profession for understating to Gibson the losses actually suffered, which understatement resulted in Gibson's inaccurate release of financial statements.<sup>97</sup>

As this case illustrates, strict securities laws against fraud were already in place. Thus, no proposed regulation and legislation would produce any better protection than current laws against fraud.

# 2. BT Securities and Procter & Gamble

In a similar charge, P&G alleged that BT traders deceived it by presenting certain financial modeling which hid risks and which led to losses of up to \$157 million before taxes.<sup>98</sup> These losses were the amount P&G owed BT under two swaps.

P&G had swapped much of its fixed income debt for a floating interest rate debt in order to take advantage of what it had hoped would be falling interest rates. Expecting the slide in interest rates to continue, P&G approached BT suggesting a swap transaction whereby P&G would benefit so long as interest rates did not rise. After refusing several of the transactions proposed by BT, P&G settled upon a transaction with BT in

<sup>94</sup> Id. ¶ 86,1¢4. The managing director told his supervisor that:

[F]rom the very beginning, [Gibson] just, you know, really put themselves in our hands like 96%... And we have known that from day one... these guys [Gibson] have done some pretty wild stuff. And you know, they probably do not understand it quite as well as they should. I think that they have a pretty good understanding of it, but not perfect. And that's like perfect for us."

95 Richard Waters, US Bank Settles Derivatives Law Suit, FIN. TIMES, Nov. 24, 1994, at 30.

<sup>96</sup> The CFTC (Commodities and Futures Trading Commission) is a sister institution to the SEC and has jurisdiction over exchange-traded derivatives. PHILLIPPE JORION, BIG BETS GONE BAD 119 (1995).

97 Former Bankers Trust Broker Settles Charges Involving Derivatives, WALL ST. J., Mar. 1, 1996, at B12.

98 Carol Loomis, Untangling the Derivatives Mess, FORTUNE, Mar. 20, 1995, at 62.

<sup>&</sup>lt;sup>91</sup> 15 U.S.C. § 77(q) (1997).

<sup>&</sup>lt;sup>92</sup> 15 U.S.C. 78(j) (1997).

<sup>&</sup>lt;sup>93</sup> 17 C.F.R. § 240.10b-5 (1996). See also In re BT Sec. Corp., Fed. Sec. L. Rep. (CCH) ¶ 85,477 (1995).

Id.

November 1993<sup>99</sup> whereby, on a notional amount of \$200 million, "P&G was to pay a floating rate . . . 75 [basis points] below commercial paper rates" for the first six months.<sup>100</sup> Following this, P&G was required to pay a floating rate "dictated by a brain twisting formula whose components would include five-year and 30-year Treasury rates as of May 4, 1994."<sup>101</sup>

P&G---First six months: commercial paper rate -.75;-----> BT Next 54 months: rate pursuant to formula -----> <----> Fixed rate ----->

The effect of this transaction was that P&G would benefit if interest rates were lower because it was being paid a fixed rate, yet if interest rates rose, it would suffer.

When interest rates did rise, P&G sued BT. Before the suit, P&G and BT had entered into another transaction more complex than the first. The formula agreed upon essentially included a band with boundaries of 4.5% and 6.10%. P&G stood to win so long as interest rates remained within this band. However, interest rates increased beyond this band. Acting on an alleged promise from BT, P&G tried to avoid this meteoric rise in interest rates by negotiating to lock in the rate which it would pay to BT. Eventually, BT and P&G settled upon a rate, but not before P&G suffered great losses and BT claimed that it made no promises to P&G. P&G's treasurer left the company, and CEO Edwin Artzt dubbed the transactions "a violation of the company's policy against speculative financial transactions."<sup>102</sup>

Although Artzt said this in hindsight, the assertion does indicate a company policy against such risky financial ventures. If a company already has such a policy in place, it is hard to imagine how the proposed legislation could have significantly protected against what transpired. Requiring that the board of directors be well-versed in derivatives trading probably would not have made much of a difference if such transactions were entered into without the CEO or board's approval. The treasurer himself would have been deemed well-versed in derivatives if interest rates had instead taken a turn for P&G's benefit. The litmus test for the board of directors that one is versed in derivatives trading seems difficult to apply. Is it the responsibility of the federal government to ensure that P&G sticks to soap?

99 Id. at 64.
100 Id. at 62.
101 Id.
102 Id. at 66.

# B. ORANGE COUNTY BANKRUPTCY—A FATE DECIDED BY VOTERS, NOT A LACK OF REGULATION

As mentioned above, much of the proposed legislation comes in response to the bankruptcy of Orange County. Orange County is the largest municipality in U.S. history to go bankrupt.<sup>103</sup> The thought of a government-run investment pool going bankrupt naturally concerns anyone whose assets are invested by a government agency. Despite Orange County's wealth, the derivatives losses have forced it to reduce funding for programs, including those benefitting children and the indigent.<sup>104</sup> Ultimately, the bankruptcy affected all county residents. However, this does not necessarily mean that increased federal regulation is the answer. Prevention mechanisms are already in place, such as the crime of fraud and the democratic election of the county treasurer.

Robert Citron, treasurer of Orange County, ran the Orange County Investment Pool (hereinafter "OPIC"). The pool consisted of 187 public entities such as cities, school districts, sanitation districts, and water authorities.<sup>105</sup> Citron made many of his investments with the securities firm of Merrill Lynch.<sup>106</sup> Naturally, as losses were realized by the county, it began to point fingers at Merrill Lynch.

Citron thought that interest rates would fall. He entered into what are known as inverse floaters, investment instruments which result in coupon payments based on the direction of interest rates.<sup>107</sup> Typically, these instruments are hedging devices that an investor would use if he had had too many transactions dependent upon high interest rates.

Citron decided to use them as an investment vehicle, betting on stable or falling interest rates.<sup>108</sup> These inverse floaters were structured notes which had become popular in the last few years, especially in 1993, when investors sought highly bullish investments.<sup>109</sup> For example, Citron invested \$100 million in a structured note issued by the Federal Home Loan Board which was structured so that it would pay 15.5% less twice the LIBOR rate:

### 15.5% - 2(LIBOR)

In this calculation, an increase in the LIBOR had a doubling effect. If the rate went up by 1%, Orange County would feel the pinch of a 2% de-

108 JORION, supra note 96, at 77.

<sup>109</sup> Lauries Goodman & Linda Lowell, Structured Note Alternatives to Fixed Rate and Floating Rate CMOs, 1 DERIVATIVES Q., Spring 1995, at 67.

<sup>103</sup> JORION, supra note 96, at 1.

<sup>104</sup> Id. at 128.

<sup>105</sup> *Id*. at 7.

<sup>106</sup> Id. at 98.

<sup>&</sup>lt;sup>107</sup> This bet on future interest rates is very similar to a swap transaction where the counterparties are predicting the future of interest rates.

crease in payments received.<sup>110</sup> Unfortunately for OPIC and Citron, interest rates increased.

The proponents of H.R. 31 have acted as if only legislation would have prevented the Orange County debacle. If this had been true, then the SEC and Orange County could not have brought causes of action when they did. Orange County has brought charges for lack of adequate warning and suitability. Mentioned *supra* in reference to H.R. 31, suitability standards are aimed at protecting the less knowledgeable investment customers from the more knowledgeable investment institutions. However, suitability requirements would allow regulators the benefits of 20/20 hindsight whenever the customer loses. The loser of this zero sum game already scrutinizes the regulatory code in order to have transactions ruled invalid, suggesting that adequate remedies are already available without the proposed legislation.

Citron, as Orange County Treasurer, held an elective office. Throughout his tenure as treasurer, he fought state regulations on his finance activities, eventually convincing the California state legislature that certain regulations should be scaled back to give him more leeway. The voters of Orange County did not give much credence to Citron's opponent, John Moorlach, in the June 1994 election for treasurer. Moorlach severely criticized Citron's risky positions and predicted the losses which Citron's positions would cause the investment pool to suffer.<sup>111</sup>

This Note is not trying to suggest that the voters really understood derivatives and clearly knew of and wanted to take such risky positions, but that Citron won the election based on his successful record of investing. Success does not come without risk. While Orange County residents seemed willing to accept the huge gains, despite the unsuitability of the investments, they immediately claimed fraud when losses occurred. To reiterate my point, if Citron violated the law, certainly the county has a case. However, if he did not violate the law, and if the suitability provisions had been in place, the county would not initially have made such tremendous gains.

Citron is by no means above the law nor immune from charges of fraud. Evidencing that there are regulations which apply to such scenarios, the SEC has brought action against Citron. The SEC alleges that, in 1993 and 1994, Citron issued official statements for county bond offerings containing "material misstatements and omissions." The complaint also alleges that Matthew Raabe, Orange County Assistant Treasurer, misrepresented OCIP's derivatives holdings by telling rating agencies that only 20% of the county's portfolio consisted of volatile derivatives

<sup>&</sup>lt;sup>110</sup> JORION, supra note 96, at 51.

when derivatives actually made up 27.6% to 42.2% of the portfolio.<sup>112</sup> If fund managers such as Raabe are going to misrepresent a fund's holding, increased disclosure will not solve the problem. As the ISDA has indicated, the current regulatory framework meets the expectations of legislators, regulators, and industry participants.<sup>113</sup>

The reason that Orange County declared bankruptcy when it did was because it did not meet its margin call requirements.<sup>114</sup> At the time of the margin call, Orange County had \$800 million in cash, \$5 billion in securities, as well as real estate tax revenues. More importantly, if these margin requirements were met and Orange County decided to ride out the storm, the county stood to recover the \$21 billion value of its portfolio along with \$300 million in interest. County residents would have made a profit.<sup>115</sup> Simply because the county did not meet its margin requirements does not necessarily seem to justify massive government intervention, especially when the county may have come out ahead.

#### C. INTERNAL CONTROLS AND THE LESSONS OF BARINGS PLC

Proponents of federal derivatives regulation argue that financial institutions have responded too slowly to the risks to which their activities expose them. Congressman Leach has noted that while commercial banks have improved internal risk management controls, other parts of the industry, such as insurance companies and broker-dealer affiliates, have not.<sup>116</sup> Nevertheless, the February 26, 1995 announcement of the collapse of Barings motivated other financial institutions to monitor their employees' derivatives activities.<sup>117</sup> If an institution does not control its traders and the derivative instruments which they purchase, other institutions like Barings could go bankrupt. Bankruptcy of a financial institution is a far greater impetus to other financial institutions than is a congressional mandate.

A single rogue trader named Nick Leeson was able to cause the collapse of Barings because he had authority not only to execute trades, but also to take charge of the "back office" which supervises the settling of trades. Essentially, Leeson placed the trades and was in charge of

<sup>115</sup> Rita Koselka, If You Can't Stand the Heat .e., FORBES, Feb. 12, 1996, at 37.

<sup>&</sup>lt;sup>112</sup> Andy Pasztor & Bruce Orwall, SEC Accused Orange County of Fraud, WALL ST. J., Jan. 25, 1996, at B5.

<sup>113</sup> JORION, supra note 96, at 37.

<sup>&</sup>lt;sup>114</sup> A margin call is made by a brokerage institution with whom the trade is executed as insurance that losses sustained can be met. As Orange County stood to lose \$1.7 billion, a margin call was made for the county to put up money as insurance that these losses could be paid. See JORION, supra note 96, at 36.

<sup>116</sup> DAILY REP. FOR EXECUTIVES (BNA), Feb. 8, 1995, at A26.

<sup>&</sup>lt;sup>117</sup> John R. Dorfman, Brokerage Firms Take Action to Detect Potential Rogue Traders in Their Midst, WALL ST. J., Nov. 29, 1995, at C1.

monitoring himself.<sup>118</sup> Leeson used derivatives (futures in particular) as an investment vehicle rather than as a cautionary hedging device.

His positions assumed that the Nikkei average,<sup>119</sup> would fluctuate very little. He bought futures on one exchange and sold them on another at a higher price. When the Nikkei average dropped as a fall out from the Kobe earthquake, Leeson purchased futures on the Singapore International Monetary Exchange (SIMEX) and the Osaka Securities Exchange, predicting that Japanese stock prices would rise.<sup>120</sup> Leeson also traded derivatives contracts on the assumption that Japanese interest rates would rise. Unfortunately for Leeson and Barings, neither Japanese stocks nor interest rates rose, and the bank became insolvent paying out hundreds of millions of dollars to meet margin requirements.<sup>121</sup>

Barings ultimately failed because there was no risk management system looking over Leeson's shoulder. Furthermore, Leeson violated existing regulations of the stock exchanges on which he was trading. Leeson pled guilty to these violations as well as to unlawfully deceiving the auditors at Barings.<sup>122</sup> For these offenses, he is currently serving a six and a half year sentence in the Tanah Merah prison in Changi, Singapore.<sup>123</sup> Leeson's actions caused the British bank to crumble, warning other financial institutions that, unless they improve internal management, they may suffer the same fate. In fact, U.S. regulators, financial analysts, and large U.S. investment banks have said that the type of losses suffered by Barings is unlikely in the United States because of controls already in place.<sup>124</sup> Hence, legislation is not necessary to stop rogue traders such as Leeson; the Barings incident will provide an incentive to financial institutions to adopt more stringent controls on their own.<sup>125</sup> Moreover, while securities firms, exchanges, and regulators can learn from this debacle,<sup>126</sup> regulators should be careful not to overregulate. They should instead allow securities firms and customers to evaluate the quality of the market.<sup>127</sup>

127 Id at 114.

<sup>118</sup> JORION, supra note 96, at 147.

<sup>119</sup> The Nikkei average is the average of the leading Japanese stocks.

<sup>&</sup>lt;sup>120</sup> Bair, *supra* note 65, at 3.

<sup>121</sup> Id.

<sup>&</sup>lt;sup>122</sup> In order to hide his positions which were going to result in huge losses for Barings, Leeson created a secret account (the notorious "8888") which he used to portray to regulators that he was well-hedged for any losses that may result from those positions. *See* NICK LEESON, ROGUE TRADER 269 (1996).

<sup>123</sup> Id. at 265.

<sup>124</sup> James F. Peltz, Collapse at U.S. Firm is Unlikely Analysts Say, Los ANGELES TIMES, Feb. 28, 1995, at D1.

<sup>&</sup>lt;sup>125</sup> Ajoy Sen, Leeson Case to Spur Tighter Financial Unit Controls, REUTERS MONEY REP., Dec. 3, 1995, at 1.

<sup>&</sup>lt;sup>126</sup> Hans R. Stoll, Lost Barings: A Tale in Three Parts Concluding with a Lesson, 3 J. DERIVATIVES 114 (Fall 1995).

### VI. CONCLUSION

There is little doubt that derivatives losses can be devastating. Congressional initiatives, however, will not necessarily increase protection, nor will they act as deterrents to fraudulent behavior any more than the fraud provisions already in place in securities laws. Conversely, if regulators move away from legislation and towards disclosure requirements, the SEC must not be overzealous.

Future legislation may require that managers of institutions trading in derivatives be well-versed in the proper application of derivatives. Under the traditional corporate governance structure, these mechanisms are already in place. For example, shareholders can remove the board of directors which is responsible for ousting management. Changes by institutional actors<sup>128</sup> already provide a good start to solving past problems.

In short, regulators should leave derivatives alone. End users should be more prudent in managing risk and speculations with a closer scrutiny of transactions. Financial institutions have already responded with tighter internal controls. Furthermore, the great costs to companies of proposed SEC regulations could actually hurt the entities the regulations are trying to help. Otherwise, future legislation, if reflective of that proposed in the last Congress, would not prevent the debacles discussed herein and would create excessive intervention.

Christian O. Nagler<sup>†</sup>

<sup>&</sup>lt;sup>128</sup> Benjamin Weiser, Six Major Wall Street Firms Agree to Voluntary Derivatives Controls, WASH. POST, Mar. 10, 1995, at B1. SEC Chairman Arthur Levitt welcomed the announced, confidential internal data reporting by banks as ". . . a very innovative way at approaching a serious issue quickly." Id.

<sup>†</sup> Candidate for J.D., Cornell Law School, 1997. B.A. Skidmore College, 1992.