

ARTICLES

FOREWORD

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In this special symposium issue, the *Northwestern Journal of International Law & Business* tackles what promises to be one of the most interesting and challenging legal fields of the 21st century: the regulation of derivatives and other complex financial products. Interestingly, this field experienced phenomenal growth and profound change during recent decades, yet is virtually guaranteed to assume even greater importance in the coming century and, accordingly, to present even greater challenges for investors, market professionals, and regulators.

Contrary to common belief, the use of derivatives to hedge against or speculate on price changes in assorted variables is not a new phenomenon. In fact, historians have discovered derivatives use as early as 2000 B.C.¹ In the United States, the state of Massachusetts Bay in the 1700's and the Confederacy in the course of financing the Civil War each issued what would today be termed "structured notes," that is, debt instruments whose payout streams are tied to an underlying reference rate, asset, or index.² By the middle part of the eighteenth century, a fully operational futures market was ongoing in Chicago.³

It was not until recent decades, however, that growth in the derivatives markets exploded, due primarily to important advances in communications and technology, the globalization of commercial and financial markets, and

¹ Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 1 (1994).

² *Id.* (describing some early instances of derivatives use).

³ *Id.*

the search by market participants for higher yields and lower funding costs.⁴ For at least the past decade, derivative instruments have comprised one of the world's fastest growing financial markets. By the middle of 2000, for example, the estimated notional amount of outstanding derivatives contracts exceeded \$105 trillion,⁵ more than four times the \$24.6 trillion outstanding at the end of 1992 (an amount which itself seemed staggeringly large at the time.)⁶

This growth has shown no signs of abating, meaning that the topics addressed by these symposium authors are not only timely, but also extraordinarily important. As recognized by the symposium authors, the derivatives markets of the twenty-first century are likely to pose new variations on old challenges, rather than to present radically new problems.

For example, all followers of major derivatives events will easily recall the large investor losses of the 1990's: Orange County, California; Barings PLC; Procter & Gamble; and Metallgesellschaft, to name just a few. This spate of losses among wealthy, seemingly sophisticated investors led many commentators to question whether sellers of derivative products should owe some level of fiduciary duty to their customers, even when the customer is a "sophisticated" investor such as these.⁷

In her contribution to this symposium, Helen Parry revisits the issue of derivatives losses by wealthy investors through an examination of the protections (or lack thereof) afforded to hedge fund investors.⁸ While noting that regulators have traditionally rightly focused their protective efforts on investors considered unable to fend for themselves, she also notes that in today's bear market, more investors are being drawn into riskier and more leveraged investments in the search for higher profits.⁹ She further notes that the "new rich" – for example, sports and media stars and dot-comers – who have large asset bases but relatively little investment experience, are particularly susceptible to aggressive or manipulative sales tactics.¹⁰ She advocates a regulatory regime that classifies investors (and the level of pro-

⁴ U.S. General Accounting Office, No. 94-133, *Financial Derivatives: Actions Needed to Protect the Financial System* 3 (1994), available at 1994 WL 2476176-77.

⁵ Press Release, Bank of International Settlements, *The Global OTC Derivatives Market Continues to Grow* (Nov. 13, 2000), available at <http://www.bis.org/press/p001113.htm>.

⁶ Jacob M. Schlesinger, *Money-Go-Round: Why the Long Boom? It Owes a Big Debt To the Capital Markets*, WALL ST. J. A1 (February 1, 2000) (quoting Swaps Monitor).

⁷ See, e.g., Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996) (advocating "meaningful risk disclosure requirements," even for sophisticated investors).

⁸ Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 NW. J. INT'L. L. & BUS. 703 (2001).

⁹ *Id.*

¹⁰ *Id.*

tection they are entitled to) based on a real assessment of investment expertise, and not on investor wealth.¹¹

United States securities law generally rejects attempts to classify investors based on real tests of sophistication or experience, and instead uses investor income as a proxy for determining investor sophistication. In fact, the perceived uncertainties inherent in the *Ralston Purina* case-by-case test of investor sophistication motivated the Securities and Exchange Commission (“SEC”) to adopt income thresholds as a test for investor accreditation in Regulation D of the Securities Act of 1933.¹² The Commodity Futures Modernization Act of 2000 (“CFMA”) follows this basic approach, by defining “Eligible Contract Participant” to include individuals with assets in excess of \$10 million, thus assuming some level of investment sophistication among wealthy individuals.¹³

Nonetheless, issues regarding how losses should be allocated between sellers and buyers when a derivatives transaction goes wrong are likely to remain prominent throughout the coming years. This is likely to be particularly true as increasing numbers of individual investors, some of comparatively modest means, enter the derivatives markets, often through hedge funds, which are capitalizing on attempts by individual investors to outperform the recent lackluster stock market by accepting increasingly small investment stakes,¹⁴ and through single stock futures (scheduled to begin trading in the United States on December 21, 2001.)¹⁵

As discussed by Frank Partnoy in his contribution to this symposium, the introduction of trading in single-stock futures — banned in the United States since the 1982 Shad-Johnson Accord — promises to pose challenges to regulators, the exchanges, and investors for many years to come.¹⁶ As Partnoy explains, the introduction of single-stock futures trading in the United States raises a host of unresolved issues, including margin require-

¹¹ *Id.*

¹² In *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), the Court stated that an offering to persons “able to fend for themselves” was not a public offering. Ex-ante determinations of which investors were sophisticated enough to fend for themselves proved difficult in practice, however. The SEC granted some relief through the Regulation D safe-harbor, which defines “accredited investor” in terms of income thresholds, rather than sophistication tests. See Reg. D, Rule 501(a).

¹³ This amount is reduced to \$5 million if the individual is managing the risk of an asset owned or liability incurred (or reasonably likely to be incurred).

¹⁴ Gregory Zuckerman, *Hedge Funds Find Room for Little Guys -- Brokers Chaperone Small Investors*, WALL ST. J., C1 (August 1, 2000) (noting that the “small stakes” hedge fund sector — which accepts individual investments of \$100,000 — is one of the fastest growing Wall Street sectors.)

¹⁵ The Commodity Futures Modernization Act of 2000, § 202(a)(5), available at 114 STAT 2763 (2000).

¹⁶ See Frank Partnoy, *Multinational Regulatory Competition and Single-Stock Futures*, 21 NW. J. INT’L. L. & BUS. 641 (2001) (discussing several implications of the single-stock futures market).

ments, the use of single-stock futures to commit securities fraud and insider trading, and the use of single-stock futures to take short positions more cheaply and effectively than currently possible through short sales of stock.¹⁷

In his contribution to this symposium, William J. Brodsky also discusses the CFMA's repeal of the ban on single-stock futures, by discussing how political infighting between the SEC and the Commodity Futures Trading Commission ("CFTC") gave rise to the ban to begin with, and arguing that the multi-regulator system of derivatives supervision in the United States — with power shared between the SEC and the CFTC — is inefficient and outdated, and should be eliminated in favor of a single regulator system.¹⁸

As Brodsky explains, United States derivatives regulation can only be understood through historical analysis.¹⁹ Specifically, derivatives regulation in this country originated as agricultural regulation — a system that is ill equipped to manage the huge and quickly growing financial derivatives markets of today.

Federal regulation of derivatives markets in the United States began with the Future Trading Act of 1921²⁰, an act pushed by farmers and their congressional representatives in an attempt to gain greater control over grain price setting from the grain middlemen (elevator operators, grain dealers, and the like). Originally, the farmers' lobby advocated a complete ban on grain futures, or at least on grain futures speculation, by requiring an existing cash position.²¹ In the end, however, they settled for a prohibitive tax on grain futures not undertaken on an authorized exchange (termed a "board of trade").²² Authority for approving boards of trade was granted to the Secretary of Agriculture.

With the Commodity Exchange Act of 1936,²³ the authority of the Secretary of Agriculture was expanded to include broker licensing and speculative position limits. In addition, jurisdictional authority was extended to

¹⁷ *Id.*

¹⁸ William J. Brodsky, *New Legislation Permitting Stock Futures: The Long and Winding Road*, 21 NW. J. INT'L. L. & BUS. 573 (2001).

¹⁹ For excellent discussions of the history of derivatives regulation in the United States see Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. REG. 279 (1997), and Jerry W. Markham, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* (1987).

²⁰ Future Trading Act, 42 Stat. 187 (1921).

²¹ Romano, *supra* note 19.

²² The Supreme Court struck down the Future Trading Act as an unconstitutional exercise of Congress's taxing power. *Hill v. Wallace*, 259 U.S. 44 (1922). Congress immediately re-enacted the statute as the Grain Futures Act of 1922 under its Commerce Clause powers. 42 Stat. 998 (1922). See Romano, *supra* note 19 at n.10.

²³ Pub. L. No. 74-675, 49 Stat. 1491 (codified at 7 U.S.C. §§ 1-15 (1994)).

cover commodities other than grains, including, cotton, butter and eggs.²⁴ These changes, however, did not alter the basic structure of derivatives regulation as an agricultural regulatory regime, designed primarily to address the needs of farmers and other members of the farming industry. This made sense at the time, as the derivatives markets were primarily agricultural in character and were used primarily by the farm industry to hedge agricultural product prices.

It was not until the Commodity Futures Trading Commission Act of 1974 that derivatives regulation first moved beyond its agricultural roots.²⁵ With the 1974 Act, Congress transferred regulation of futures markets from the Secretary of Agriculture to an independent agency — the CFTC. Part of the impetus behind the 1974 Act was the perceived need to address the regulation of non-agricultural commodities, such as metals and foreign currency. Accordingly, the new CFTC was given regulatory jurisdiction (with a few relatively narrow exceptions) over *all* futures contracts (other than transactions in foreign currency not conducted on a board of trade), and the SEC retained its then-current jurisdiction — stock and stock options.²⁶

Although this division of power was not seen as problematic at the time (after all, there were no stock futures yet in existence) it set the stage for Mr. Brodsky's criticisms over 25 years later, by creating a system of dispersed United States financial market regulation. Of course, the problems attendant in such a dispersed system were unforeseen at the time, because no one could predict the drastic changes that were about to take place in the derivatives markets.

Those changes emerged only one year later, however, when in 1975 the Chicago Board of Trade ("CBOT") introduced the first financial futures contract: a contract on Ginnie Mae pass-through certificates.²⁷ This contract assumes extraordinary historical importance for two reasons. First, the SEC (which regulated the underlying certificates) unsuccessfully opposed trading in the contract, thus beginning a long-standing turf battle between the SEC and the CFTC. Second, it marked the beginning of a permanent

²⁴ Romano, *supra* note 19.

²⁵ Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended at 7 U.S.C. § 4(a) et seq. (1994)).

²⁶The definition of commodity was expanded to include nearly every agricultural commodity, except onions, as well as "all other goods and articles ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(3).

The provision exempting foreign currency from the CFTC's jurisdiction is known as the "Treasury Amendment," so named because it was added to the bill at the request of the Treasury Department. By 1974, federally chartered and supervised banks had an active foreign exchange business, which they did not want disturbed by CFTC regulation. See Romano, *supra* note 19.

²⁷ For discussions of the Ginnie Mae contract battle see Romano, *supra* note 19; Brodsky, *supra* note 18.

change in the character of the derivatives markets: from primarily agricultural, to primarily financial.

Given its failure to prevent the CFTC exchanges from trading in financial futures, the SEC shifted course in 1981 and authorized one of its regulated exchanges, the Chicago Board Options Exchange ("CBOE"), to begin trading Ginnie Mae options. Although the CBOT successfully sued in the Seventh Circuit to prevent the CBOE contracts, the SEC and CFTC reached an agreement in order to avoid protracted and expensive future litigation.²⁸ This agreement gave rise to the 1982 Shad-Johnson Accord (named after the then-current SEC and CFTC chairmen), which prohibited futures on all individual stocks and non-exempt bonds.²⁹ The Accord preserved the CFTC's jurisdiction over all futures, but required consultation between the SEC and the CFTC regarding the approval of stock index futures. Finally, the Accord granted the SEC veto power over stock index futures and options on such futures that were not broadly based.

The problems and limitations of the Accord became evident almost immediately.³⁰ "Hybrid securities" that were not explicitly covered by the Accord quickly developed, generating legal uncertainty as to their treatment under the commodities and securities laws. The over-the-counter ("OTC") derivatives markets began exponential growth, yet uncertainty as to whether such products might be deemed illegal off-exchange futures arguably hampered the development of the market, and fears that the entire market would move offshore to avoid its uncertain legal status in the United States were frequently present. Finally, both the SEC and the New York Stock Exchange blamed difficulties in coordinating multiple regulatory efforts for exacerbating the 1987 stock market crash.³¹

Although the CFMA addressed some of these issues, by permitting single-stock futures, subject to CFTC and SEC regulation, and by address-

²⁸ *CBOT v. SEC*, 677 F.2d 1137 (7th Cir.) vacated as moot, 459 U.S. 1026 (1982).

²⁹ The fight over stock futures basically centered around the CFTC's insistence that it had jurisdiction over all futures, including stock futures. The SEC, however, fought the CFTC's attempts to regulate stock futures, claiming that the CEA and CFTC rules did not address issues such as market manipulation, insider trading, suitability, and margin requirements in the same manner as did the securities laws and SEC rules. Accordingly, the SEC expressed some well-founded concerns that the lighter regulation of stock futures could destabilize the underlying securities markets and undermine the SEC's efforts to promote market integrity in that area. Unable to reach an agreement, both sides determined to ban single stock futures outright, and to conduct a study regarding the issue. That study was never conducted. See Brodsky, *supra* note 18 at 3.

³⁰ For more detailed discussions of these problems see Romano, *supra* note 19; Brodsky, *supra* note 18.

³¹ As Romano notes, such criticisms, though plausible, were also self-serving. If the CFTC's jurisdiction over stock index futures could be blamed for exacerbating the crash, then the SEC's political position would be strengthened when it attempted to wrest control of stock futures from the CFTC during the upcoming CFTC reauthorization hearings. Romano, *supra* note 19.

ing many of the legal uncertainties surrounding hybrids and OTC derivatives, it left the basic structure of the old system — first developed in the 1920's and 1930's when separate regulation of the securities and derivatives markets made sense because those markets rarely if ever overlapped — intact. Like Mr. Brodsky, many other commentators — including former President George Bush, Sr. — have urged Congress to merge the CFTC and SEC into a single regulator. As Mr. Brodsky notes, however, political forces, including oversight of the CFTC and the SEC by separate congressional committees (agriculture and commerce, respectively), each unwilling to cede power to the other, has sustained the current, highly imperfect system, and is likely to do so for some time to come.³²

³² See also, Romano, *supra* note 19 (discussing the role of congressional committees in sustaining the U.S. system of multiple financial regulators).