Incorporation May Not Mean Sophistication: Should There Be a Suitability Requirement for Banks Selling Derivatives to Corporations

Jason M. Rosenthal
INCORPORATION MAY NOT MEAN SOPHISTICATION:
SHOULD THERE BE A SUITABILITY REQUIREMENT FOR
BANKS SELLING DERIVATIVES TO CORPORATIONS?

JASON M. ROSENTHAL,*

INTRODUCTION

Bankers Trust Company recently reached a settlement agreement with Gibson Greetings, Inc., an international manufacturer of greeting cards, whereby it will bear a $14 million loss from derivative investments.1 The settlement comes several months after Gibson Greetings sued Bankers Trust, a pioneer in the use of derivatives, in federal district court for losses suffered investing in high-risk derivative securities, relying on advice from Bankers Trust.2 Among its complaints, Gibson Greetings alleged the bank did not consider the corporation's best interests as an unsophisticated investor.3 Although it had dealt in derivatives before, Gibson Greetings premised this allegation on the facts that these previous dealings were limited in scope, that it advised Bankers Trust of its unwillingness to speculate, and that it "justifiably believed that it had entered into a special relationship of trust and confidence with Bankers Trust."4

This represents the first time a corporation has sued for losses suffered from an over-the-counter derivatives transaction;5 that is, one conducted through the broad market of brokers dealing securities by telephone or computer, rather than through the facilities of a securities exchange. While the case did not actually go to trial, it raises concerns over the soliciting of derivative securities not only to individual

* J.D. Candidate 1997, Chicago-Kent College Of Law; B.S. Finance, Indiana University.
2. See id. Gibson Greetings sought recovery under a theory of misrepresentation, alleging Bankers Trust took advantage of the company by not accurately disclosing the risk involved in the securities transaction. See id.
3. See id.
investors, but to major corporations investing substantial assets in these high-risk securities.

In a related case, Procter and Gamble ("P&G") also filed suit against Bankers Trust, alleging it induced P&G to enter into interest rate swaps\[6\] by negligently providing false information.\[7\] P&G also sued under a theory of breach of fiduciary duty.\[8\] This theory allegedly arose from Bankers Trust's promise that P&G could accurately rely on its advice concerning swap transactions, and that this promise, along with P&G's reliance on this promise, gave rise to a fiduciary duty which Bankers Trust breached.\[9\] The two parties recently agreed to settle out of court, and Bankers Trust has "agree[d] to absorb as much as $150 million" in losses that P&G suffered on the interest rate swaps.\[10\]

Traditionally, the financial world considered corporations\[11\] such as these to be among the most sophisticated investors, requiring no regulatory protection.\[12\] Initially, regulators designed suitability rules to protect investors with "little financial know-how."\[13\] Such suitability rules are designed to ensure that customers buy the "right" products given their financial goals, and the rules shift this responsibility from the clients to the brokers themselves.\[14\] The rules provide that a broker may recommend a security to a client only if it conforms to the client's investment objectives, as determined by information obtained by the dealer.\[15\]

6. Interest rate swaps involve a contractual agreement to exchange a package of interest-rate forward contracts with another party. See Donald L. Horwitz, Derivatives, I: The Basics on Terms and Risks, BUS L. TODAY, Sept.-Oct. 1995, at 42.


8. Fiduciary duty is defined as "[a] duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person," and it is the "highest standard of duty implied by law." BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

9. See Bahlke, supra note 7, § I.C.2.


11. A "corporation" is defined as "[a]n artificial person or legal entity created by or under the authority of the laws of a state." BLACK'S LAW DICTIONARY 340 (6th ed. 1990).


14. Id. Some suitability rules might require dealers to justify to regulators each transaction they make. See id.

Most banks, viewing corporations as sophisticated entities and thus unneeding of this protection, presumed that corporations possessed the ability to make their own informed decisions about whether or not a particular security or derivative was suitable for them. In fact, corporations have actually argued for deregulation in this area over the course of the past few years. In the aftermath of the Bankers Trust cases, however, and the continuing development of more complex derivative securities, regulators are taking a new look at whether or not corporations are in need of protection.

This Note examines the need for such protection from derivative investments sold by banks. Part I of the Note provides a brief overview of derivatives and the functions they serve in the financial arena. This introduction specifically addresses the use of derivatives by corporations. These securities play an important role in the day-to-day operations of corporations and managements' ability to hedge against the many risks associated with conducting business both in the United States and abroad.

Part II discusses the current legislation in this area, which consists mostly of administrative regulations (e.g., the Securities and Exchange Commission, Office of the Comptroller of the Currency). Although several of these regulations provide some type of suitability protection, they are not industry-wide standards applicable to all dealers, but rather affect only specific sectors of the industry—mainly those dealers belonging to the self-regulatory organization responsible for the regulation. The Office of the Comptroller, which regulates banking activity, enacted similar regulations which apply directly to banks selling derivatives. These regulations, while not designed as suitability rules, create incentives for banks to provide customers with adequate protection when buying derivative securities.

The focus in Part III shifts to proposed regulatory alternatives applicable to dealers selling derivatives, including banks. These alternatives cover a broad spectrum. They range from shifting the full burden of determining suitability to the dealer, to advocating a traditional arm's length standard in which dealers may assume customers are sophisticated enough to enter the transaction without any protection.

Part IV analyzes what direction these regulations should take in regard to their applicability to corporate end-users of derivatives. The

16. See generally id.
17. No per se "common-law cause of action [exists] for a broker-dealer's failure to make a suitability determination." Id. § II.A.2.
Conclusion reached from an examination of the proffered alternatives suggests an environment absent of strict regulation in the form of suitability rules. This is because of the complexity of applying a uniform standard to the very diverse group of corporations employing the use of derivatives, and the fact that many corporations are unwilling to pay for added protection. Instead, a better alternative is a free market approach. Under this scenario parties may, at their option, contract for the appropriate level of investment services and advice. This allows those unwilling to pay for additional protection the free will to continue using derivatives at their discretion, while at the same time leaving more unsophisticated parties the opportunity to seek additional investment advice.

I. THE USE OF DERIVATIVES IN THE FINANCIAL ARENA

Derivatives have recently become an important tool in the management of the daily risks encountered by major corporations. Nevertheless, many executives utilize derivatives either for speculative purposes, or without full knowledge of their potential impact on the corporation. As will be shown, derivatives do serve an important function when used to reduce risk, but when used improperly only serve to both create new risk and increase existing risk.

Derivative securities are thus named because they "derive" their value from an underlying financial asset.\textsuperscript{18} Explained in basic terms, such an investment is essentially a "bet" as to how the particular underlying asset will perform over time.\textsuperscript{19} While this may sound simple enough, over twelve hundred types of derivatives exist today, many formulated by "financial laypersons" with doctorates in mathematics and physics.\textsuperscript{20} They take on names such as "death-backed bonds," "inverse floaters," and "heaven and hell bonds."\textsuperscript{21} Some are so com-


\textsuperscript{19} 60 Minutes: Derivatives (CBS television broadcast, July 23, 1995).

\textsuperscript{20} Id. The 60 Minutes broadcast describes the formulation of these new, complex derivatives as "the financial equivalent of genetic engineering." Id. An example of one such derivative is the following: "CPN Rate 4.3 to 2/95; 6.22% to 2/96; 7.8% to 2/97; Thereafter @ 11%/6mo $LIBOR. Call only if 6MO $LIBOR = 5/5%. Stepped inverse 6MO $LIBOR/Linked 'IAN'." Id.

\textsuperscript{21} Markham, supra note 4, at 353.
plex that not even industry experts can discern their purpose or calculate expected gains and losses.22

The use of derivatives "ha[s] grown rapidly [in] the past ten years."23 In 1994, they accounted for twenty percent of the profits of the brokerage houses and investment banking firms selling these securities.24 The amount of outstanding derivatives in the over-the-counter market alone is estimated to be at least $12 trillion.25

Derivatives can be grouped into two broad types of investments.26 A forward-based contract involves a promise by one party to buy a specified quantity of an underlying asset, at a specified price, on a specified date, from the other party.27 An option-based contract, on the other hand, gives the buyer the choice of purchasing or not purchasing the underlying asset at a specified price on a specified date.28 Just as two basic types of derivatives exist, there are two established mediums of purchasing them.29 Exchange-based derivatives trade on established financial exchanges, and are subject to "fairly comprehensive regulation,"30 while over-the-counter ("OTC") derivatives are often customized to meet the needs of the parties involved in the transaction.31

Whether or not a derivative is suitable for a corporation depends, in part, on the intended use of that derivative.32 While many purchase derivatives solely with speculation in mind, derivatives were originally designed, and serve an increasingly important role, for corporations "hedging" certain day-to-day risks.33 By purchasing the appropriate

22. See 60 Minutes: Derivatives, supra note 19. Jim Grant, a Financial Analyst appearing on 60 Minutes, when asked to explain what the derivative formula found in footnote 20 meant, responded that he did not understand it. Id.
23. Senior Deputy Comptroller for Capital Markets Douglas E. Harris, Remarks Before the International Swaps and Derivatives Association, Barcelona, Spain (March 23, 1995), reprinted in Bahlke, supra note 7, at Exhibit C.
24. See 60 Minutes: Derivatives, supra note 19.
25. See id. The actual estimation is somewhere between $12 trillion and $35 trillion. See Markham, supra note 4, at 353.
26. See Horwitz, supra note 6, at 38.
27. See id.
28. See id. at 42.
29. See Goldman, supra note 18, at 1118.
30. Id. The bulk of this regulation comes from the Futures Trading Commission and the Securities Exchange Commission. See id.
31. See id. The flexibility feature of OTC derivatives has consequently made these instruments more complex, and hence more difficult to regulate. See id.
32. See id.
derivatives, corporations can essentially lock in otherwise variable market rates.\textsuperscript{34}

An example of the relevance of this function is explicitly provided in P&G's 1994 annual report, in which it states that the company "is subject to market rate risk from exposure to changes in interest rates and currency exchange rates and enters into various financial instrument transactions to manage these exposures."\textsuperscript{35} For example, because the company's financing and cash management activities are vulnerable to interest rate changes, P&G "utilizes interest rate swaps,\textsuperscript{36} including foreign currency interest rate swaps, that have the effect of converting specific debt obligations of the Company from fixed to variable rate, or vice versa, as required."\textsuperscript{37} Additionally, in order to manage the risk resulting from exposure to fluctuations in currency exchange rates, P&G utilizes foreign currency swaps\textsuperscript{38} as well as forward exchange contracts and options.\textsuperscript{39}

When used properly, derivatives give corporate managers the ability to control and transfer certain variable risks,\textsuperscript{40} thereby allowing them to determine to some degree the market environment in which they will do business.\textsuperscript{41} This is an increasingly important function in today's global economy because, by providing a wide array of risk management tools, derivatives allow for the effective allocation of

\textsuperscript{34} See id. at 1014. As an example, a corporation wishing to insure against an increase in the interest rate can buy a derivative whose value is tied to that rate. Thus, while a rise in the interest rate may increase the corporation's cost of doing business, that increased cost will be offset by a corresponding increase in the value of the derivative security. See Interview with Corey L. Fisher, Independent Trader, Rand Financial Services, in Chicago, Ill. (Nov. 14, 1995).


\textsuperscript{36} In such a transaction, "one party agrees to pay another a floating rate of interest on a . . . 'notional' amount of principal for a specified period of time; in return, it receives a . . . fixed rate of interest on the same amount of . . . principal for the same period of time." John C. Dugan, Derivatives: Netting, Insolvency, and End Users, 112 BANKING L.J. 638, 639 (1995). It should be noted that the parties do not make the actual full interest payments to one another, but rather simply exchange the net gain or loss. See id.

\textsuperscript{37} PROCTER & GAMBLE, supra note 35, at 10.

\textsuperscript{38} See id. The primary purpose of a foreign currency swap is to hedge against the risks associated with changes in foreign exchange rates. See Christopher L. Craig, Comment, The Appropriate Income Tax Treatment for the Assignment of Notional Principal Contracts, 36 St. Louis U. L.J. 797, 797 n.3 (1992).

\textsuperscript{39} See PROCTER & GAMBLE, supra note 35, at 11-12. "The impact of the changes in the value of these instruments typically offsets changes in the value of the underlying transactions." Id. at 12.

\textsuperscript{40} See Horwitz, supra note 6, at 45.

credit and sharing of risk, leading to lowered “cost[s] of capital formation and stimulation of economic growth.”

Aside from the ordinary risk of the devaluation of derivatives, there is another major concern which must be addressed when dealing in derivatives. This is the problem of valuing derivatives. Most securities are traded on major markets (e.g., NYSE, NASDAQ), and thus price quotations are readily available and tend to reflect the current, up-to-the-minute price. The derivatives market is much smaller though, partly because many investments are designed to suit the particular parties’ needs. This not only makes these investments highly illiquid, but also makes them difficult to price. Thus, end-users are often unable to obtain price quotes or even reliable estimates of value. As a result, end-users are heavily reliant on their dealers to provide them with accurate pricing information and, therefore, may not be able to monitor their positions effectively in order to control loss.

Reliance on dealer valuation poses an additional concern. At many firms, traders are directly responsible for pricing a derivative’s market value. This structure allows for potential conflicts of interest, because a trader’s compensation is often tied to the securities in which they invest.

Although end-users often inherit a great deal of risk when investing in derivatives, they are not the only parties in such transactions to experience risk. Derivatives dealers themselves are also subject to a multitude of risks. For example, “operational risk” refers to the “risk of loss associated with human error; miscommunication or fraud; management or system failure; or inadequate procedures and controls.”

44. See id.
45. An end-user is generally the party seeking to initiate the transaction, and the one who will ultimately be required to buy or sell a given asset. See Thomas C. Singher, Note, Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?, 18 FORDHAM INT’L L.J. 1397, 1403 (1995).
46. See Harris, supra note 23.
49. See id.
This risk may be especially prevalent when dealing with derivatives because of the complex transactions which are likely to occur.\textsuperscript{51} Another type of risk is "reputational risk," or the risk that dealers may lose part of their client base due to a perception that they cannot effectively manage derivative transactions.\textsuperscript{52} Additional risks include "liquidity risk," in the event the dealer is unable to meet its funding requirements for derivatives transactions, and "legal risk," which is simply the risk that a transaction is not valid or enforceable as a matter of law.\textsuperscript{53}

Although the risks to dealers and customers are plentiful, derivatives remain an important business tool used to effectively manage even greater risks (such as fluctuations in currency exchange rates, inflation, etc.). Because of their risk-hedging benefits when used properly, corporations will continue to use derivatives. Yet even as the use and importance of derivatives grow, little regulation exists as to their sale.

\section*{II. Current Legislation Regulating the Sale of Derivatives}

For the past several years there has been a "steady and dramatic" increase in the institutionalization of derivatives markets.\textsuperscript{54} The dominance of institutional investors led to a call for reduced regulation of the financial markets.\textsuperscript{55} Arguments were made that these institutions were too sophisticated to be subjected to the regulation designed to protect the average investor.\textsuperscript{56} Securities and Exchange Commission ("SEC") Regulators responded to these requests by removing much of the regulations as applied to these institutional investors.\textsuperscript{57} As a result, the "primary" gap in the structure of securities regulation concerns the "inapplicability of suitability rules" to, and the "lack of

\begin{itemize}
\item \textsuperscript{51} See id.
\item \textsuperscript{52} See id. § 1.E. This risk can also affect the ability of the dealer to attract new clients. See id.
\item \textsuperscript{53} See id. § I.H-I.
\item \textsuperscript{54} Markham, \textit{supra} note 4, at 350. Institutional investors are normally said to include large commercial firms and wealthy individuals maintaining the ability, or the capital to retain third-party advisors, to adequately assess the risks involved in complex investments. See id. at 346 n.1.
\item \textsuperscript{55} See id. at 353.
\item \textsuperscript{56} See id. at 353-54. Much of this initial regulation arose after the Stock Market Crash of 1929, and was designed to "protect [the type of] unsophisticated investor[ ]... who had been... badly damaged" by that Crash. Id. at 354.
\item \textsuperscript{57} See id. The justifications for this reduced regulation included increased market efficiency, and the basic presumption that institutional investors possess the ability to determine what information is needed to make an informed investment decision. See id. at 357-58.
\end{itemize}
[comprehensive] regulation” of, dealer banks selling derivatives to institutional investors.\textsuperscript{58}

Despite the substantial losses realized by derivatives end-users, Congress has been slow to develop comprehensive legislation regulating the sale of derivatives.\textsuperscript{59} Instead, much of this responsibility has fallen on the shoulders of administrative agencies. Even so, these agencies focus on assuring that dealers obtain and disclose the necessary information concerning the risks of derivatives, instead of requiring some evidence that ensures a derivative transaction is suitable for the customer.\textsuperscript{60} Even in cases where regulators have attempted to classify certain derivatives as securities, thereby subjecting them to broad SEC regulations, Wall Street innovators have countered such action by devising even more sophisticated financial instruments that do not fall under the established definition of “security.”\textsuperscript{61} As a result, the regulation that currently exists consists of a patchwork of private obligations and narrow public law.

In light of the settlement between Gibson Greetings and Bankers Trust discussed above,\textsuperscript{62} the Federal Reserve Bank of New York became the first organization to take direct action against an individual derivatives dealer.\textsuperscript{63} Under an agreement with the Federal Reserve Bank, Bankers Trust agreed to several provisions in regards to the sale of leveraged derivative transactions.\textsuperscript{64} While the agreement falls short of a suitability requirement, one that would shift responsibility for determining the appropriateness of a client’s derivatives transactions entirely to the dealer, it requires Bankers Trust to ensure that each end-user maintain the capacity to comprehend the terms and risks of the transaction; and to disclose to each of its clients such information as would be vital to that comprehension.\textsuperscript{65} Also, because of the dependence derivative customers have on their dealers to provide price valuations, Bankers Trust must regularly provide end-users with

\textsuperscript{58} John Duncan & Mary Jo Quinn, Regulatory Outlook, \textit{BANK ACCT. \\ & FIN.}, Summer 1995, at 43, 45.

\textsuperscript{59} See Baird et al., supra note 47, at 40.

\textsuperscript{60} See id. at 47. It should be noted that some regulation does exist, but this deals mostly with fraudulent conduct on the part of derivatives dealers. See id.


\textsuperscript{62} See supra text accompanying notes 1-13.

\textsuperscript{63} See Baird, supra note 47, at 46.

\textsuperscript{64} See id. A leveraged derivatives transaction is one in which the value of the derivative rises or falls faster than the underlying asset from which it is derived. See id.

\textsuperscript{65} See Patrikis, supra note 15, § III.B (citing Written Agreement By and Among Bankers Trust New York Corporation et al., at 3-7 (Dec. 5, 1994)).
indicative quotes and other related information, including disclosure of the basis for these valuations.66

While these rules apply only to Bankers Trust, other broad reaching regulations exist that apply to all derivatives dealers. For example, the Securities Exchange Act of 193467 requires derivative dealers to join a self-regulatory organization ("SRO").68 These SROs, which have "substantial enforcement authority," impose additional regulations on their member organizations.69 Among the significant regulations, many SROs have formulated suitability, or "know thy customer" rules, which apply to their members.70 For example, article III, section 2 of the National Association of Securities Dealers' ("NASD") Rules of Fair Practice states that "in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer" based upon facts disclosed by the customer regarding "his other security holdings and as to his financial situation and needs."71 While the rule does not specify information that must be collected by dealers in regards to noninstitutional customers, dealers still must obtain sufficient information on which to justify their suitability determination.72

Banks, however, remain the major players in derivatives dealing,73 and the Office of the Comptroller of the Currency ("OCC") and the Federal Reserve regulate bank activities.74 In 1993, the OCC took the first step in addressing the issue of appropriateness of derivatives

66. See id. The other information includes the material terms and risk of the derivative transactions, along with sensitivity analyses illustrating the range of outcomes at maturity. See id.
68. See Bahlke, supra note 7, § II.A.
69. Duncan & Quinn, supra note 58, at 44.
72. See id., § I.A.2. The requisite information for noninstitutional customers includes net worth, tax status, and investment objectives. See id.
73. While their involvement in derivatives dealings has been strictly limited in the past, banks have recently become the most significant dealers in the marketplace. See Goldman, supra note 18, at 1115.
74. See id. at 1121-22. The majority of banking activity is regulated by these agencies. See id.
INCORPORATION MAY NOT MEAN SOPHISTICATION


76. See id. The bank must make this assessment based on its knowledge of the counterparty’s policies and procedures for entering into derivatives contracts. See id.


78. See Comptroller, supra note 76, at 2-3.

79. See Bahlke, supra note 7, § II.A.4(a)(7).


82. Id.

83. See Comptroller, supra note 75, at 1. A secondary objective was to “develop a set of [b]est [p]ractices” to serve as a guide for banks. Id.

84. See id. at 3. Most banks had some formalized “know thy customer” policy, along with self-policing systems and ongoing training programs. See id. at 1. Additionally, these banks
action-oriented approach. Such an approach reflects the notion that banks seem more concerned with developing solid, long-term relationships with their customers, rather than simply churning out as many derivatives transactions as possible.

Credit officers are usually the banking officials responsible for determining customer appropriateness. The necessary information is normally obtained through standard questionnaires and customer profiles. Such standardized documentation, however, does not always disclose the requisite information. While this is a problem with individual investors, it is especially difficult with large corporations, which often have volumes of information. This calls for significant cooperation from corporate managers, who must be willing to disclose and perhaps explain confidential information.

Aside from disclosure problems, the findings of the OCC’s performance review seem to indicate that banks are complying with BC 277 and taking proper steps to ensure derivatives transactions are appropriate for their clients. Thus, although the OCC did not enact BC 277 as a suitability requirement, it effectively serves to operate as one, and indeed, one that appears to work. Given the frequent complexity of the transaction involved, the wide range of client sophistication, and the dramatic growth within the financial community of the use of derivatives, one might expect that the market would welcome the development of any sort of regulatory guidance. Nevertheless, some argue that the scattered legislation coming from a multitude of administrative organizations is not comprehensive enough to have a lasting effect on the regulation of derivatives transactions, and that these regulations, in their existing form, may be causing more confusion than protection. This has prompted several organizations to respond with broadly sweeping alternative regulations.

insist they would not allow an inappropriate transaction to go through, even if requested by the customer. See id. at 3.

85. See id.
86. See id.
87. See id. Appropriateness, as in ensuring that the customer and derivatives transaction are suitably matched.
88. See id. at 4.
90. See id.
91. This information includes financial capacity, business characteristics, and corporate goals. See COMPTROLLER, supra note 75, at 5.
III. PROPOSED CHANGES

As mentioned at the beginning of this Note, the financial community traditionally viewed corporations as sophisticated investors. Apparently little has been learned, however, from the multitude of corporations reporting losses from derivatives. Even so, "[d]erivatives are here to stay," and the potential for loss is great. A recent survey conducted by the accounting firm of Ernst & Young discovered that seventy-five percent of the companies polled did not employ independent risk-management teams. Furthermore, fifty-five percent of these companies fully authorize traders to use derivatives on behalf of the company.

In crafting a workable suitability requirement, several basic building blocks must be established. For example, upon which party should the burden fall in determining whether a particular derivative is suitable? Should the burden be equally shared, or should the parties be required to negotiate this burden themselves?

John P.C. Duncan, in a report to the Task Force on Derivatives of the Banking Law Committee, suggests four alternate standards regarding the appropriateness of derivatives transactions. The first suggested standard has been termed by Duncan an "Advisor/Fiduciary" standard. Under this proposed level of regulation, "[a] dealer must (a) obtain all customer information reasonably required to determine whether a transaction is in the best interests of the institutional customer and (b) refrain from a transaction with a customer that does not appear to be in the customer's best interests."

This seems to reflect "the current standard applicable to ... advisors and ... fiduciaries when exercising investment discretion on be-

92. See supra text accompanying notes 12-13.
94. Patricia Murphy, Vice President of Fixed Income Trading, Ontario Teachers' Pension Plan Board, Address Before the Canadian International Futures and Options Conference (Sept. 21, 1995), quoted in McIntosh, supra note 93, at C1.
95. The survey included 143 investment firms in the United States, Britain, France, and Ireland that together manage over $535 billion. See Sesit, supra note 48, at 13.
96. See id.
97. See id.
98. Partner at Jones, Day, Reavis & Pogue (Chicago Office).
100. Id. at 1. This would likely be "an overstatement of the current standards appl[ied] to ... investment advisor[s] who ... recommend," but do not have discretion to affect, derivative transactions. Id.
half of their customers.”101 While adoption of this approach on an industry-wide basis may reduce losses by uninformed investors, a suitability requirement modelled after this standard would very likely place too great a financial burden on the parties to make it effective. Banks would have increased costs resulting from the affirmative duty to gather information, which would in turn simply be passed on to the customers—the corporations themselves. This standard also presupposes that all corporations desire, or should desire, such protection irrespective of its increased costs.

The second proposed alternative, modified suitability, suggests that “a dealer should obtain and consider the information reasonably necessary to determine whether an institutional customer is sophisticated regarding a proposed transaction.”102 If the dealer finds the customer is sophisticated, the transaction may be entered into at arm’s-length;103 otherwise, the dealer should either deny the transaction or become an advisor.104

The goal of this alternative is to place “the burden on the dealer[s] to obtain [the necessary] information,” rather than simply allowing them to rely on the information provided by the customer.105 Also, it requires banks to take on the role of an advisor, should a seemingly unsophisticated party wish to do business with them. This is a role many banks may be willing to take on, and yet a role that many corporations would not wish to pay.

Duncan’s third alternative is a modified arm’s-length standard: “Unless unreasonable to do so based on information possessed by dealer representatives participating in a proposed transaction, the dealer may assume the institutional customer is sophisticated and enter into the transaction at arm’s-length.”106

Such an alternative moves away from placing an obligation on the dealer to obtain information from the customer, and instead creates an assumption that the customer is indeed sophisticated. This benefits dealers in that, unless there is information to the contrary, they may assume the investor is sophisticated and thereby shift the responsibility—and the consequences—of a failure to disclose pertinent information to the client. Moreover, although it may seem to take away

101. Id.
102. Id. at 2.
103. See id. This of course applies absent some other written agreement between the parties.
104. See id.
105. Id.
106. Id. at 5.
investors' protection, it may very well encourage corporations or other investors to disclose all of this pertinent information to the dealer regarding their trading sophistication, so that dealers themselves will be able to evaluate the investors' sophistication knowing "all the facts."

The final alternative proposed by Duncan is a traditional arm's-length standard. Under this alternative, "[a] dealer may assume the institutional customer is sophisticated and enter into any transaction at arm's length (unless the dealer agrees in writing with the customer on a different understanding of the relationship)."\(^\text{107}\)

This standard represents the current law applicable to derivatives dealers only recommending transactions to institutional customers, and not acting in an advisory or fiduciary capacity. Under this standard, protection is not automatically provided. In the event that customers desire additional protection, they can contract with the dealer to alter their relationship to include the proper investment advice.\(^\text{108}\) While it eliminates protection afforded the institutional customer by providing an assumption of sophistication, at the same time this standard seems to advocate a free market approach — one absent of regulation in which customers decide for themselves how much assistance is needed.

The private sector has also proposed regulation of its own in an attempt to avoid harsh governmental regulation.\(^\text{109}\) Many of these proposals come from the Group of Thirty, a respected group of "end-users, dealers, academics, accountants, and lawyers involved in international financial markets."\(^\text{110}\) Their recommendations call for an "independent market and credit risk-management function."\(^\text{111}\) This would presumably require a dealer's "analysis of the reasonableness of the proposed activities in relation to the organization's overall financial condition and capital levels."\(^\text{112}\)

With alternative regulatory suggestions coming from both the public and private sector, it may be difficult to reach an agreed upon standard. The suggested standards set forth above encompass broad

107. *Id.* at 6.
108. *See id.*
110. Duncan & Quinn, *supra* note 58, at 47.
111. *Horwitz, supra* note 6, at 44.
112. *Id.*
alternatives, ranging from placing the burden for determining suitability on the dealers themselves, to shifting this burden to corporate clients by assuming client sophistication sufficient to comprehend transactions without the assistance or advice of dealers. Thus, crafting the "ideal" standard requires a detailed analysis of this spectrum of proffered alternatives.

IV. Analysis

While corporate losses from derivatives transactions have become more prevalent, the injection of regulatory protection into the marketplace will not cure existing problems. This is because it was not the absence of regulation that led to these large derivatives losses, but rather the continuing absence of internal corporate controls, and the ineffectiveness of corporate executives seeking outside advice when needed. Private organizations on both sides of derivatives transactions have undertaken voluntary steps to remedy these ongoing problems, which until recently, did not manifest themselves in the form of such large monetary losses. While industry experts may not be in favor of a strict suitability requirement, the proposed reform may nevertheless represent a "necessary, welcome, and thoughtful effort to enhance market participant understanding."\textsuperscript{113}

For example, the Derivatives Policy Group, comprised of six leading derivatives dealers, recently adopted a voluntary framework for acceptable "rules of practice" applicable to derivative dealers like themselves.\textsuperscript{114} Four basic principles support this framework, the first being the implementation of management control. This requires "comprehensive" internal risk management control systems" that address a diverse genre of risks.\textsuperscript{115} Enhanced reporting of derivative-related information, and evaluation of risk in relation to capital, are among the other disclosures to be made under the recommended guidelines.\textsuperscript{116}

Despite such suggestions, one can hardly argue that Fortune 500 companies such as P&G lack the resources necessary to evaluate their financial positions. P&G itself has acknowledged that it "maintains internal controls which are designed to provide reasonable assurance that transactions are executed as authorized and accurately recorded

\textsuperscript{113} See Bahlke, supra note 7, at Exhibit B.

\textsuperscript{114} See Wander et al., supra note 50, § VII.B.

\textsuperscript{115} See id. These risks include market, credit, liquidity, legal, and operational risks. See id.

\textsuperscript{116} See id.
Incorporation May Not Mean Sophistication

and that assets are properly safeguarded." In a letter to Arthur Levitt, Jack Fields, the Chairman of the Subcommittee on Telecommunications and Finance, agrees that "[s]ophisticated investors must not be relieved of their own obligation to manage and supervise their investment strategies." Indeed, it seems that many corporate investors want to "have [their] cake and eat it too: [they] want the benefits of their good investments, but not the "losses" from their bad ones. Although this is not an entirely unique legal strategy, lawyers seem to be seeking "victim status" for their corporate clients, no matter how large or small.

A distinction must be made, however, between corporate giants such as P&G, and closely held corporations, where stock ownership is not widely dispersed and a few shareholders are in control of corporate policy. Although P&G's lawsuit filed against Banker's Trust was likely an important impetus to regulators wishing to re-examine the need for corporate protection from poor investment advice, P&G, number thirteen on the Fortune 500 list, may actually serve as a bad example of corporations requiring such protection. This is apparent simply by examining the company's 1995 annual report in which it reported net sales of over $30 billion and net earnings of $2.7 billion.

Like other investors though, corporations will continue to make and lose money, regardless of their size. Thus, an across-the-board rule applying to organizations based on incorporation will not accomplish the proper regulatory objectives. Although corporate status carries with it many privileges and protections, it hardly seems reasonable to presume that simply by becoming incorporated, an organization suddenly becomes an entity in need of special protection. This would surely be advantageous to corporations that would be able to shield themselves from derivatives losses in many instances, simply

117. Procter & Gamble, supra note 35, at 23.
118. Chairman of the SEC.
119. Letter from Jack Fields, Chairman, Subcommittee on Television and Finance, to Arthur Levitt, Chairman, Securities and Exchange Commission, reprinted in Bahlke, supra note 7, at Exhibit B. Fields means for this comment to apply absent a fiduciary relationship between the customer and dealer-bank. See id.
120. Markham, supra note 4, at 361.
121. Id. at 363.
122. See Procter & Gamble, supra note 35, at 2.
124. See id. These earnings do not include the $102 million charge against 1993 and 1994 net earnings related to P&G's losses from two interest rate swaps. See id. at 27 n.1.
125. Examples of such privileges and protections of incorporation would respectively be the increased ability to raise funds and the limited liability of shareholders.
by labeling the instrument sold to them as unsuitable. This could lead to further frivolous litigation.

Any adopted standard must be a subjective one, to be applied on a case-by-case basis, to a highly diverse group of corporate derivative end-users. In light of industrial giants like P&G, such a standard may be especially appropriate considering that many smaller investors are increasingly finding their resources are not sufficient to allow them to analyze and monitor derivatives transactions. As a result, these parties are often forced to hire additional personnel, or more commonly, obtain supplementary expertise by contracting with a third party.126

For this reason, any call for protection must include an assessment of the true complexity of derivatives. It is arguable that aside from some exotic transactions, derivatives are not as complex a security as they appear to be. This perception is consistent with the notion that the problem may not be derivatives themselves, but rather the investment executives who misuse them in unadvised bids to make quick money instead of using them for risk management. Herein may lie the real danger because any security can prove dangerous when misused.127 Corporations, however, unlike individual investors, often have built-in market incentives which prevent them from engaging in such speculation. These might include a decline in the corporation's stock price, shareholder dissatisfaction, and the fear of losing one's job.

Responding to the alleged complexity of derivatives, one industry expert stated that "[i]f derivatives are not used because they appear complex, it's a rather feeble excuse."128 Indeed, it has been suggested that with the right information, any counterparty should be able to make a decision as to the appropriateness of a derivatives transaction.129 However, it should be noted that all corporations might not have access to such information. Thus, instead of enacting suitability rules, a better approach might be to focus on the issue of disclosure.130 This would require the dealer to inform investing corporations of how much they stand to gain or lose in different scenarios. Of course, the issue would still exist as to whether once this information is disclosed the dealer is relieved of all liability; and whether the burden is then

126. See Markham, supra note 4, at 383.
127. See Fisher, supra note 34.
128. Murphy, supra note 94.
130. See Unsuitable, supra note 12, at 18.
shifted to corporations that must, with this disclosed information, determine for themselves whether a derivative investment is indeed suitable.

Up to this point, most of the legal claims filed against dealers by end-users such as P&G and Gibson Greetings have been based on a theory that the derivatives dealer breached some type of fiduciary duty. Liability under a suitability rule would presumably not require any such relationship to exist. There certainly must be some due diligence requirement on the part of corporate end-users though, for even effective regulation "cannot substitute for effective management." In fact, one industry expert suggests that the Bankers Trust cases discussed above would not exist, absent a failure on the part of P&G and Gibson Greetings to effectively supervise personnel through an adequate set of internal controls. Another issue related to the enactment of a suitability rule is that it would "undermine the finality" of derivatives transactions. This in turn may "create ... uncertainty regarding the economic risk position" of investors.

Perhaps the best approach is to return to the basic principles underlying contract law. The simplest solution indeed involves the basic principles of contract law, and would have the parties work out the terms of their relationship before doing business. This provides private autonomy to the parties, allowing them to determine for themselves how much protection they wish to subscribe to. In a perfect world, parties would work out these details in advance, and a default rule shifting responsibility to either party would not be necessary, nor would this Note. Unfortunately, this is not the case, probably in part due to the fact that investors often do not anticipate the serious losses which can occur in derivatives transactions. As already established

135. Id.
though, "[w]hen the customer does not understand a transaction or is clearly assuming too much risk, it will rarely benefit the bank to proceed with the transaction."\textsuperscript{136} For this reason, banks retain an incentive to ensure that customers do not enter into inappropriate transactions, regardless of what course of action regulators take.\textsuperscript{137}

The scenario in which all parties seem to benefit most effectively is indeed a deregulated market; one in which parties themselves decide how much protection to include in their sales contract. Given the diverse structures, assets, and objectives of the many existing corporations, devising a broad standard to be universally applied would be a virtual impossibility. Adopting a free-market approach, however, would permit those parties wishing to reap the benefits of deregulation able to do so by acting on their own merits and relying on their own resources to guide their investments. On the other hand, those corporations in need of sound investment advice can simply enter into such an agreement with their derivatives dealer. This allows companies currently benefitting from relaxed regulation to continue to enjoy these benefits, while at the same time allowing those needing protection to seek it out themselves.\textsuperscript{138} A suitability rule would unnecessarily alter the traditional "arms-length" relationship between dealers and investors. Furthermore, markets function most efficiently when the parties to a transaction are able to enter into the deal without a duty to "serve the interests of their counterparties."\textsuperscript{139}

In several studies conducted by industry experts, all of those surveyed agreed that "the most important line of defense for ensuring that the risks of derivatives are limited is a 'conscious and disciplined' approach to risk management based on sound principles and practices."\textsuperscript{140} Even if a suitability requirement were enacted, determining a derivative's suitability for a corporation may be extremely difficult and, at best, would represent the bank's subjective opinion.\textsuperscript{141} In addition, the duties required by a suitability rule would also create responsibilities that are "unavoidably vague in scope and conflict with the arm's length nature of [t]ransactions."\textsuperscript{142} What may make such an

\textsuperscript{136} Duncan, supra note 80, at 26.

\textsuperscript{137} See id.

\textsuperscript{138} Certain agencies in fact encourage investors to seek independent investment advice when they are unwilling or unable to take responsibility for their own decisions. See Patrikis & Virzera, supra note 134.

\textsuperscript{139} Schmedlen, supra note 77, at 1472.

\textsuperscript{140} Horwitz & Mackay, supra note 42, at 15.

\textsuperscript{141} See Unsuitable, supra note 12, at 18.

\textsuperscript{142} Patrikis & Virzera, supra note 134.
assessment even more difficult is the unwillingness of many corporations to disclose the closely-held information necessary for making such a determination.\textsuperscript{143} Although banks will already possess certain information about their customers, corporations will be forced to reveal even more confidential information, such as detailed product data, long and short-term goals, and other information, which if leaked, could hurt that corporation's competitive edge.\textsuperscript{144}

It is also unlikely that many corporations would be willing to bear the increased costs which dealer-banks would be forced to implement in the wake of facing liability from potential lawsuits. And, paradoxically, if corporations are afforded increased protections, they may have incentives to take bigger speculative risks, or be less likely to inform themselves of the risk, knowing that should they suffer losses they may have statutory recourse against the dealer.\textsuperscript{145}

For these reasons, regulators should be wary of enacting suitability regulation, which would create unneeded incentives for banks to ensure derivatives transactions are appropriate, mainly because these incentives are already in place through the form of self-enacted regulations such as BC 277. Additionally, such regulation would infringe upon the free will of corporations to decide how much investment advice or assistance they require. By allowing the parties to a derivatives transaction the ability to decide for themselves how much protection and advice are bargained for, corporations can apply their own test as to the benefits of additional protection, and the costs they are willing to pay for it.

\textbf{Conclusion}

When used properly, derivatives are an essential tool in the management of risk. Yet when used without certain precautions, in an unsupervised manner, derivatives may only serve to increase existing risk and create new risk. The existence of a suitability standard, one which would require banks to determine whether transactions are appropriate for the corporations entering into them, would not offer the same advantages to all corporations. This is in part because corporations are too diverse a group to enact this type of regulatory protec-

\textsuperscript{143} See Unsuitable, supra note 12, at 18. This includes information which is not required to be disclosed in the corporation's annual report, which is governed by generally accepted accounting principles.

\textsuperscript{144} See Telephone Interview with Whitney L. Keer, The Natural Group (Oct. 15, 1995) (notes on file with author).

\textsuperscript{145} See Unsuitable, supra note 12, at 18.
tion which will apply simply upon a company's filing for incorporation.

By allowing corporations to operate in an environment free of such regulation, each corporation can make a determination for itself as to whether additional protection is required. If a corporation decides outside investment advice is needed, it can simply enter into a fiduciary or contractual relationship with a securities dealer that will provide these desired services. At the same time, this allows those benefitting from deregulation to continue to reap those benefits. Finally, it has been suggested that perhaps corporations should enact their own suitability test, one applied to its executives and the dealers selling them securities.146

146. See id. What seems to really be suggested is that corporate officers determine whether executives are making the proper decisions, and whether the dealers selling them securities are providing them with suitable advice and services.