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INDUSTRIAL, ECONÔMICO E FINANCEIRO

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DERIVATIVE'S SUITABILITY

LUIZ GASTÃO LEÃES FILHO*

SUMMARY: 1. Introduction — 2. The nature of derivatives; 2.1 Types of derivatives; 2.1.1 Basic classification; 2.1.2 Trading classification; 2.1.3 Application classification; 2.2 The legal status of derivatives — 3. Current rules and solutions for derivatives suitability; 3.1 Securities laws; 3.1.1 Self-regulatory organizations rules; 3.2 Commodities rules; 3.3 The common law approach; 3.4 Banking rules; 3.5 The written agreement between Bankers Trust and the Federal Reserve; 3.6 The derivative's industry voluntary standard for the sale of derivatives — 4. Conclusion.

1. Introduction

Recently, newspaper published several reports about various events of huge private and public losses from derivatives. Among them was the Orange County event, where derivatives generated an approximately two billion dollar in losses for that County.[1]

Other huge monetary losses' incidents were related to two of Banker Trust's customers: Proctor & Gamble[2] and Gibson Greetings. Together they asserted they had losses of almost $ 180

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For detailed consideration on the security concept in Brazilian law, see Luiz Gastão Paes de Barros Leães, "O conceito de 'security' no direito norte-americano e o conceito análogo no direito brasileiro" in Revista de Direito Mercantil (1974) 42-60, Ary Oswaldo Mattos Filho, "O conceito de valor mobiliário" in Revista de Direito Mercantil (1985) 30, and Nelson Eizerik, "O conceito de valor mobiliário e o alcance da Lei n. 7.913/89" in Aspectos Modernos do Direito Societário (1992) 147-163.

About Swaps and derivatives operations in Brazilian market see Silvio H. Yanagawa, "Das compensações Múltiplas (nettings) nos "swaps" e "derivatives" in Revista de Direito Mercantil (1994) 58-65. Recent figures shows that only in the Brazilian market were negotiated until 1994, 41.543 interest/exchange currency rates swaps agreements and 5.954 interest rates swaps agreements. See IFR April 1994 Development Bank report, page 32. See about the regulation on Brazilian OTC market in Resolution 2.042/94 and Circular 2.402, both issued by Brazilian Central Bank, and swap regulation in manual de Normas e Instruções, Rules 2.19, also issued by Brazilian Central Bank.

Arnoldo Wald, "O mercado futuro de índices e os valores mobiliários" in 57 Revista de Direito Mercantil 5-18, provides a good review on the Brazilian index Market.

Futures and fowards in Brazilian market are reported by Luiz Gastão Paes de Barros Leães, "Liquidação compulsória de contratos futuros" in 657 Revista dos Tribunais 44-55.

(1) New York Times. December 14, 1994. Sallie Hofmeister. "Orange County's Battered Fund to be Sold in Effort to Limit Loss".

(2) Wall Street Journal. October 28, 1994. Paulette Thomas, "Proctor & Gamble Sues Bankers Trust Because of Huges Losses on Derivatives".

million in swaps' transactions with that Bank.[3] Big losses from derivative's transactions also happened with two colleges: City College of Chicago and Odessa College. Even banks have experienced unbelievable big losses when dealing with derivatives. The most famous incident involving a bank happened with Barings PLC, a British investment bank, more than two hundred-years-old, which went bankrupt after a 27 years-old Singapore based trader, lost more than 1 billion dollars in a speculative investment on derivatives of Japanese securities indexes.[4]

Those losses have trigged an increase questioning about the current methods of trading and regulating derivatives. Investors, policymakers, and dealers started to reevaluate methods of regulating derivatives' trades, trying to find answers for a number of doubts: Is it necessary to regulate the procedure for the sale of derivatives? Does everybody should be allowed to invest in these financial instruments? Should all investors be treated equally? Are the regulations nowadays existents adequate? If it's imperative to introduce a suitability rule, who should bear the responsibility for determining whether a derivative is suitable for certain investor? Should the dealer who arranged the transaction, or the investor be in charge to bear that responsibility?

The questioning about the need for regulation over derivatives, is mainly true for these traded over the counter (OTC), rather than derivatives traded in exchange markets,[5] considering the OTC derivatives' market has not been covered by the commodities and securities regulation. OTC derivatives, market size still uncertain, however estimations project its volume over hundreds of billion dollars.[6] Thus big enough to worry the industry and policymakers. Derivatives traded in exchanges are standardized and somehow better known by investors. Only by the fact of being traded in exchanges also provide them with more strict regulation from the exchanges as well from the institucional regulators that supervise the exchanges.

In this work I will try to cover these questions, analyzing the legal nature of the OTC derivatives, the existing suitability rules, in both securities and commodities trades, the several approaches for solving the suitability problem, including, besides others, the common law guidelines.

My intentions with this work are not to profoundly discuss all the existing rules and solutions, nor to dictate a magic resolution for the problematic hereby exposed. What I intend is to understand what are the problems, identify tendencies of solutions towards the issue, and finally give my impressions on derivatives' suitability.

2. The nature of derivatives

In order to discuss derivatives' suitability, it's crucial to understand what derivatives are. They are financial instruments that derive their value from some other instrument or asset, such as interest rate, exchange rate or index.[7]

(3) New York Times. December 23, 1994. Saul Hansell, "Settlement by Bankers Trust Unit".

(4) New York Times. March 3, 1995. A Special Report: "Big Gambled, Lost Bets Sank a Venerable Firm".

(5) For example securities options, and future exchange.

(6) John A. Lindholm, "Finical Innovation and Derivates Regulation" — Minimizing Swap Credit Risk Under Title V of Future. Trading Practices Act of 1994 Column. Bus. L. Rev. 73, 78.

(7) Kenneth R. Kapner & John F. Marshal, "The Swaps Handbook: Swaps and related Risk Management Instruments" 494 (1990); "Global Derivatives Study Group, Group of

There are many types of derivatives. An option, for example, is a type of derivative instrument that secures value from the underlying security[8] which may be purchased by exercising the secures value from the underlying security, that may be purchased by exercising the option.

Unfortunately, neither policymakers, neither courts have yet fully established derivatives' legal status. This situation creates even more difficulties to introduce new rules to combat abusive sales practices, that came together with the growth of derivatives' market.[9]

2.1 *Types of derivatives*

2.1.1 Basic classification

Essentially derivatives can be classified in four different basic categories: forwards, futures, options and swaps.

Forwards and futures are, fundamentally, contracts that obligate a party to buy or sell and underlying asset at a specific price and date in the future. The key difference between the two is that future contracts are standardized products that must be traded on an exchange, whereas forwards are individually negotiated.[10] Probably the most commons are futures on financial indexes, and those involving commodities, such as oil, precious metal or agricultural products.[11]

Options are, maybe, the most known kind of derivatives. It gives to the holder of the option the right to buy or sell an underlying asset at a particular price on or before a certain date. In a stock option one can have either a "call" stock option, or a "put" stock option. For

Thirty, Derivates: Practices and Principles" 28 (1993); Adam R. Waldman, "OCT Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss? "43 Am. U. L. rev. 1023, 1026 (1994). The problem with this type of definition is that it conceivably covers many agreements or other arrangements that arise in the course of commercial transactions that probably should not be subject to comprehensive regulation. Congress has made several attempts to define derivatives more precisely, at least in the swaps area. The Financial Institution Reform, Recovery, and Enforcement Act of 1989 defines swap agreement as a "rate swap agreement, basis swap, commodity swap, forward rate agreement, interest rate future, interest rate option purchased, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement ... or any other similar agreement" or combination thereof. 12 U. S. C. s 1821 (c) (8) (D) (vi) (1988 & Supp. V. 1993). A similar definition exists in the Bankruptcy Code. See 11 U.S.C. s 101(55) (Supp. V 1993). This approach, however, may lag significantly behind the process of financial innovation, thereby leaving regulatory gaps.

(8) In this example the underlying security is the "underlying asset" of derivative instrument called "option". "Underlying asset" is simply the asset that gives value to the derivative security. Consequently, the underlying asset of a stock option is the stock over which a purchase option can be exercised in certain future date. David L. Scott, Wall Street Words 96 (1988).

(9) Geoffrey B. Goldman, "Crafting a Suitability Requirement for the Sale of Over-The-Counter Derivatives: Should Regulators. Punish the Wall Street Hounds of Greed". Columbia Law Review, June 1995.

(10) General Accounting Office, Financial Derivatives: Actions Needed to Protect the Financial System, 27 (1994).

(11) Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 Seton Hall L. Rev. 1, 1 (1994). Despite the general idea that derivatives is a highly modern financial instrument, Markham notes that derivatives of agricultural commodities have been used in one form or another for several thousand years and that the Confederacy developed fairly complex financial derivatives during the Civil War.

example, the holder of a "call" stock option will have, in a certain date, the right to buy a specified stock, at a previously stipulated price.[12] The "put" stock option, on the other hand, gives to its holder the right to sell a specified stock, at a specified price. This right has to be exercised in a certain date, or other pre-established period of time.

Swaps, which are the largest component of the OTC derivatives' market,[13] are basically agreements between two parties who, based on an agreed formula, compromises themselves to make payments to each other, in a certain date. Swaps can be based on currency exchange rates, on commodity's price, on equity indexes or on interest rates.[14]

Probably the most usual and simple type of swap is the one based on interest rate. Therefore we will take advantage of this simplicity to try to better understand swaps. In an interest rate swap agreement one party is obligated to pay periodically a fixed amount off interest on a specified sum of money — called the "notional principal amount" — in return for a stream of payments based on a floating interest rate.[15] Swap agreements are used to hedge against changes in interest and foreign exchanges' rates. They allow parties to manage the risks of their exiting obligations that are sensitive to interest rates, allowing, some times, a party to borrow money more cheaply.[16] For that reason they are even more difficult to regulate and to understand.

2.1.2 Trading classification

Based on how are traded, these four basic derivatives' categories can be

(12) Among other factors, the value of the option will, largely, depend on the movement of the price of the underlying stock related to the option price. See Fischer Balck & Myron Schols, "The Pricing of Options and Corporate Liabilities", 81 J. Pol. Econ. 637 (1973). See also Henry T. C. Hu, "Misunderstood Derivatives: The Causes of Information Failure and the Promise of Regulatory Incrementalism", 102 Yale L. J. 1457, 1474 (1993) (discussing evolution of modern finance theory and its application to valuing options and other derivatives).

(13) Daniel P. Cunningham et al., "An Introduction to OTC Derivatives, in Swaps and Other Derivatives in 1994", at 121, 126 (1994). The notional value of interest rate swaps in 1992 was estimated at about $ 3.9 trillion.

(14) Just as matter of curiosity, I must say that swaps agreement has becoming a very common financial instrument in Brazilian financial market. It's mostly traded over-the-counter, and sometimes are used by Brazilian banks to by-pass rules that limits the rate of remuneration that banks can give on demanding deposits.

(15) Henry T. C. Hu, "Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm", 138 U. Pa. L. Rev. 333, 347 (1989). The "notional principal amount" rarely changes hands; it is simply the reference for determining the fixed and floating interest payments. It is not necessarily useful in determining the actual value of the instrument. If a party has an obligation to pay a creditor interest based on a floating rate but fears that interest rates will rise, it may make sense to enter into a swap in which it would pay according to a fixed rate. In return, it would receive enough money to pay its other obligation, thereby protecting itself against an increase in rates. Of course, it would lose money if interest rates fell, as it would be committed to paying the higher fixed rate.

(16) In some cases, a party might be able to borrow more cheaply at a fixed rate than at a floating rate because of its creditworthiness or other factors commonly called as market imperfections. If it would nonetheless prefer to pay a floating rate, it could borrow at the fixed rate and then enter into an interest rate swap. In doing so, it has in effect created a floating rate loan that is less costly than if it had borrowed directly.

classified in two different groups. One is compound by derivatives traded on organized exchange market. The other is compound by derivatives traded over-the-counter (OTC). All of the futures agreements and a great number of the options' contracts have been standardized and are traded on established exchanges. Despite the possibility of complexity and risking of these derivatives, they are more familiar and have already been regulated by either the Commodity Future Trading Commission or the Securities and Exchange Commission.

OTC derivatives, in contrary, are not traded on exchanges and are characteristically negotiated individually between the participants. For that reason they come in a variety of distinct forms, what implicates in a non-standardization of these derivatives. This factor often implicates in more complexity and less predictability in their performance.[17]

2.1.3 Application classification

Another way to classify derivatives is related to their application. The uses of derivatives mostly fall in four different categories: asset/liability management, creation of synthetic asset of liabilities, hedging and speculation. In an asset/liability management, users can engage in derivatives' transaction with the purpose to balance a possible mismatch with assets and liabilities.[18]

Another possible use for derivatives appears when investors use them to create "synthetic assets of liabilities".[19] For example, if a company would prefer to buy an investment with a fixed rate of return, but under current conditions can get a better return with a floating rate instrument, it can buy a floating rate instrument and then use a swap or other derivative to create a synthetic asset and obtain the desired fixed return.[20]

Hedging against adverse changes in interest or exchange rates, prices of stock or commodities, or indexes, is an additional common use for derivatives.[21]

(17) Geoffrey B. Goldman, "Crafting a Suitability Requirement for The Sale of Over-The-Counter Derivatives: Should Regulators "Punish the Wall Street Hound of Greed". Columbia Law Review, June 1995.

(18) For example a small bank or thrift institution may have a short-term, variable rate liabilities, such as depositors' funds, but long-term, fixed asset, such as home mortgages. If interest rates rise, the bank may find it more difficult to pay interest on deposits, as income from its assets will not change. As a result, it may be beneficial to enter into an interest rate swap, in which it will pay the fixed proceeds from its assets in return for a stream of floating rate payments that it can use fund its liabilities. Daniel P. Cunningham et al., "An Introduction to OTC Derivatives, in Swaps and Other Derivatives in 1994", at 131-132 (1994).

(19) Daniel P. Cunningham et al., "An Introduction to OTC Derivatives, in Swaps and Other Derivatives in 1994", at 132 (1994).

(20) On the liabilities side, currency swaps is commonly used by companies that issue debt abroad, in order to eliminate some of the risks of dealing with foreign currencies. For example, the company can arrange a swap through which it exchanges a certain payment in dollars for sufficient amounts of the foreign currency to meet its interest obligations to foreign creditors. From the company's perspective, the synthetic liability made this type of financing is not much more difficult than raising money domestically. See Daniel P. Cunningham et al., An Introduction to OTC Derivatives, in Swaps and Other Derivatives in 1994, at 132 (1994).

(21) By purchasing derivatives that offset the risks they face in their other activities, companies can ensure a cash payment that will compensate them for losses caused by underlying market movements. Daniel P. Cunningham et al., "An Introduction to OTC Derivatives, in Swaps and Other Derivatives in 1994", at 133 (1994).

Finally, derivatives can be used by investors in an attempt to speculate, much as it's normally done with any other investment. Not surprisingly, it is in this last group that investors seem to have experienced the most trouble.[22]

Given the different types of derivatives and applications we can understand the difficulty to constitute a suitability rule, that would impose if certain derivative instrument is suitable for a particular investor, or not. If the problem was only focused in derivatives that are appropriate for hedging or balancing asset/liability mismatch, there would be a better possibility that an objective rule could be created. However when think about derivatives used for the creation of synthetic investment or for speculation, how can someone find if a particular derivative is suitable for this kind of investors. Those are problems that we have to face and think about when dealing with the creation of derivatives' suitability rules.

2.2 The legal status of derivatives

As said before, derivatives' legal status has not yet been clearly introduced. Most of the difficulty for establishing that legal status resides in the fact that the legal status of OTC derivatives in uncertain. OTC derivatives do not fit perfectly in any one of the financial regulatory areas; securities, commodities, or banking. Besides the fact that some derivatives are securities, such as stock options, all of them can not be perfectly characterized as securities. If they could, they would be subject to the existing securities suitability rules. The problem is that the OTC derivatives' market embraces a wide variety of instruments, some of which contain elements recognizable as securities or commodities. As a result, it may be difficult to know which set of rules applies to any particular derivative.

Not having a clear legal status for derivatives created a division on the authority in charge of regulating and controlling derivatives. The Securities and Exchange Commission (SEC) has authority over derivatives related to securities,[23] currency options traded on securities exchanges, and over certificates of deposits.[24]

The Commodities Futures Trading Commission (CFTC) has authority over futures on groups or indices of securities, options on such futures, and options on foreign currency not traded on securities exchange.[25]

Finding jurisdiction for swaps constitutes also a problem. Technically swaps would be better fit under the Commodity Exchange Act (CEA), what would implicate in following its rule that forces all futures contracts to be traded on

(22) General Accounting Office, "Financial Derivatives: Actions Needed to Protect the Financial System" (1994), at 25.

(23) For example options on securities, on groups and indices of securities.

(24) See 7 U.S.C. s 2a(i) (1988); 15 U.S.C. s 77b(1)(1988); Susan C. Ervin, "OTC Derivative Markets and Their Regulation: Working Paper on Commodity Futures Trading Commission Regulatory Framework", C882 ALI-ABA 97, 101-02 (1994), available in Westlaw, ALI-ABA Database.

(25) Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments", 25 Seton Hall L. Rev. at 17 n. 62 (1994); and See 7 U.S.C. s 2a(i) (1988); 15 U.S.C. s 77b(1) (1988); Susan C. Ervin, "OTC Derivative Markets and Their Regulation: Working Paper on Commodity Futures Trading Commission Regulatory Framework", C882 ALI-ABA 97, at 102 (1994). The SEC effectively has a veto over an attempt by the CFTC to establish a contract market for futures on indexes of securities.

exchanges,[26] includind swaps. Nevertheless, CFTC regulations expressly excepted from CEA's provisions swap transactions, apart, however, from the antifraud rules,[27] which still applies to all swaps.

In general, is possible to state that swap agreements are not securities within the definitions of the Securities Act Exchange Act. Nonetheless, last year, the SEC decided that where the swap agreement contains "embedded options", those options may be securities within the scope of its jurisdiction.[28] In its administrative proceeding against a subsidiary of Bankers Trust (BT Securities), the SEC demanded that it had violated the antifraud provisions of the securities act when its client (Gibson Greetings) was misled in the sale of derivatives that contained embedded debt options.[29] Having that SEC's decision in hands, Proctor & Gamble, another complaint against Bankers Trust, amended its lawsuit against the mentioned Bank, presenting that the sale of interest rate and currency swaps violated the securities laws.[30]

It's important to note that extent of SEC's authority over these derivatives is still unclear, and no court has decided this subject and neither has ratified SEC's position. Until any court decision is released in this matter that doubt will stay undefined.

Due to who are the biggest players with OTC derivatives, these financial instruments are overseen through the agencies that control those players. Most

(26) 7 U.S.C. s 6(a) (1988 & Supp. IV 1992) requires that most contracts for the purchase or sale of a commodity for future delivery be conducted on or subject to the rules of a Commission-approved board of trade. In 1992, s 6(c) was added, which allows the CFTC to exempt transactions between "appropriate persons" from the exchange trading requirement.

(27) See 17 C.F.R. s 35.2 (1994). The exemption only applies to agreements between eligible swap participants where the creditworthiness of any party "having an actual or potential obligation under the swap agreement would be a material consideration in" determining the terms of the agreement. Id. An eligible swap participant, as defined in 17 C.F.R. s 35.1 (1994), includes banks, investment companies, commodity pools with assets exceeding $ 5 million, corporations or other businesses with assets exceeding $ 10 million (a corporation ned only have a net worth of $ 1 million if the swap is in connection with the conduct of its business, and there is no net worth requirement if its obligations are guaranteed by another eligible swap participant), ERISA employee benefit plans with assets over $ 5 million, any governmental entity (including subdivisions of a state), broker-dealers, and any natural person with assets over $10 million.

(28) See BT Sec. Corp. Admin. Proc. File N. 3 — 8579, 1994 SEC LEXIS 4041 (S.E.C. 1994); SEC Announces Institution & Settlement of Proceedings Against BT Securities Involving Derivative Securities Sold to Gibson, SEC News Release 94-180, Dec. 22, 1994, 1994 WL 710062 (S.E.C.). Apparently the SEC's authority derives from the fact that the swap contained an inseparable ("embedded") option based on the value of a debt security. For criticism that the SEC's new position may overstep its authority and create unnecessary and harmful new uncertainty about the status of swaps. John C. Coffee Jr., "Bankers Trust Settlement: Whither the Swaps Market?", N.Y.L.J., Jan. 26, 1995, at. 5.

(29) BT Securities consented to an SEC order finding that it violated the securities antifraud rules, s 17(a) of the Securities Act and s 10(b) of the Exchange Act and rules thereunder. The order also found that BT had caused Gibson to violate the reporting requirements of s 13(a) of the Exchange Act. Coffee argues that the SEC could have reached the conduct in the Gibson case without having to use an expansive definition of securities that could include many swaps. See Coffee, supra note 28, at 6.

(30) G. Bruce Knecht, P & G Amends Lawsuit Naming Bankers Trust, Wall St. J., Feb. 7, 1995, at. A3, A14.

of derivatives' traders in the United States of America are converged in a number proximate to 15 banks and securities firms.[31]

Banks, which activities on derivatives have not yet been restricted, like happened with most securities and commodities futures trading, are the predominant player with OTC derivatives.[32] They are differently regulated from securities firms or even their affiliates. Major banks' derivatives trading are regulated by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve.[33] Securities broker-dealers are regulated by SEC and self-regulatory organizations, such as NASD or NYSE.[34] However, in order to avoid SEC's restrictive rule, as well as self regulatory organization's oversight, securities firms deviated their derivatives transactions to unregistered affiliates.

Despite all these different types of derivatives' dealers and their distinct regulators, they have the same kind of problem and concern: the suitability of the derivative offered to determined investor.

3. Current rules and solutions for derivatives suitability

Presently, securities and commodities laws deal with issues of investor's protection in different ways, depending in part on the nature of the instrument and of the buyer. Normally, securities law imposes more responsibility on the broker, while commodities laws tend to leave matters more in the hands of purchaser. Actions for breach of fiduciary duty and fraud provisions provide a common law alternative that coexists with federal securities and commodities regimes.

3.1 Securities laws

With no doubt, securities laws are the most rigorous and developed of investor's protection. Securities regulations present two ways of addressing the issue of suitability for several securities: bright-line rules, and requirements that brokers tailor recommendations to the particular situation of an individual customer.

Bright-lines rules are those where it is imposed fewer restrictions on investors that meet certain characteristics, which qualified them in a small number of sophisticated, investors, who are deemed to have enough knowledge and experience in financial market, and so who are capable to fend themselves.

(31) General Accouting Office, "Financial Derivatives: Actions Needed to Protect the Financial System", at 7 (1994).

(32) By the end of 1992, large banks were deemed to detain around 70% of United States OTC derivatives market, even though the securities' market share was growing. General Accouting Office, "Financial Derivatives: Actions Needed to Protect the Financial System", at 11 (1994).

(33) The Federal Reserve regulates bank holding companies and state-member banks (State Banks which decided to be affiliated to the Fed. Reserve). The Federal Deposit Insurance Corporation and state banking agencies have authority over other institutions. The OCC, that is a part of the Treasury Department, has jurisdiction only over national banks.

(34) Although the SEC has authority to regulate the conduct of broker-dealers directly and to review the rules of the self-regulatory organizations (SROs), in practice much of the regulation is left to the SROs. The NASD and the stock exchanges have their own rules governing the conduct of their members. They also have their own enforcement and disciplinary proceedings, usually subject to appeal to the SEC. Geoffrey B. Goldman, "Crafting a Suitability Requirement for The Sale of Over-The-Counter Derivatives: Should Regulators. Punish the Wall Street Hounds of Greed", Columbia Law Review, June 1995.

Examples of bright line rules are in Role 506 of Regulation D[35] and in Rule 144A.[36] Those kinds of rules, however, were not yet addressed to try to resolve the problem of derivatives' suitability.

3.1.1 Self-regulatory organizations rules

Those are the rules that establish requirements for broker-dealers, have already deal with the issue of financial instruments' suitability, including derivatives' suitability. They involve subjective case-by-case determiantions, that try to ensure the broker belief that the investment is appropriate for the specific client. Instead of coming from SEC's regulators, these kinds of suitability rules arrived mostly from the Self Regulatory Organizations (SROs). Probably, the most important of these rules is the one enacted by the National Association of Securities Dealers (NASD), that agglomerate most of the broker-dealers. NASD imposed Article III, Section 2 of its Rules of Fair Practice requiring that "[i]n 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 upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[37] With regard to derivatives, the policy requirements states that a member makes every effort to familiarize themselves with customer's ability to meet the risks involved and to make customers aware of any pertinent information.[38]

The New York Stock Exchange (NYSE) has a rule that requires a member firm to use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by that member firm.[39] The American Stock Exchange (AMEX) has a corresponding "know-your-customer" provision; Rule 411.[40]

These rules, however, do not explicitly impose the determination of the suitability of the investment. They just require that the broker take the necessary steps to try to know the customer status.

3.2 Commodities rules

Commodities regulators always avoided imposing a suitability requirement. CFTC, for example, considered and

(35) Section 4(2) of the Securities Act, 15 U.S.C. s 77d(2) (1988), exempts from the registration statement and prospectus requirements of s 5 "transactions by an issuer not involving any public offering." Judicial interpretations of this section have often considered investor sophistication to be necessary for a claim that the s 4(2) exemption applies — outside of the SEC — created safe harbors. C. Edward Fletcher, III, Sophisticated Investors Under the Federal Securities Laws, 1988 Duke L. J. 1081, 1120-21.

(36) See 17 C.F.R. s 230144A (1994). Luiz F. Moreno Trevidno, "Access to U.S. Capital Markets for Foreign Issuers: Rule 144A Private Placements", 16 Hous. J. Int'l L. 159, 165-66 (1993), and see 17 C.F.R. s 230.144A(a)(1)(i) (1994). Registered dealers are considered qualified institucional buyers if they invest and own at least $ 10 million in unaffiliated securities. See id. at s. 230.144A(a)(1)(ii). The Rule also does not exempt the transaction from the securities antifraud rules.

(37) NASD Rules of Fair Practice art. III, s 2(a), reprinted in NASD Manual (CCH) P 2152 (1994).

(38) Policy of the Board of Governors, in NASD Manual, P 2152, at 2048.

(39) New York Stock Exchange Rule 405, reprinted in N.Y.S.E Guide I(CCH) P 2405 (1994).

(40) American Stock Exchange Rule 411, reprinted in Am. Stock Ex. Guide (CCH) P 9431 (1994).

rejected a suitability rule for futures commission merchants (FCMs).[41] In Phaccelli v. Conti Commodities Services, CFTC emphasized that its position that a claim of unsuitability alone under Section 4b can not serve as basis for action. It places greater responsibility on the buyer to determine whether the investment is suitable, at least as long as there is no fraud or mispresentation and as long as appropriate initial disclosures have been made.

3.3 *The common law approach*

Common law actions, mainly those based on breach of fiduciary duty, provide an important alternative to redress unsuitability claims against dealers and advisors,[42] since they generally owe fiduciary duty to their customers. SORs rules such as from NASD and NYSE can also provide basis for this kind of actions. These rules might constitute basis for a breach of fiduciary duty case, but the fact that existing case law does not indicate clearly if fiduciary duties will or will not apply to derivatives' transaction,[43] may constitute an obstacle for making use of this alternative.

The idea that banks traditionally have no fiduciary duties to their depositors or borrowers, may constitute another obstacle for those kinds of claims, when against banks. In my opinion, yet, banks trading with derivatives, and acting as brokers, do owe fiduciary duties to the buyer of the derivatives, who may or may not be a depositor of that bank. Nevertheless, this position still has to be developed in courts, what creates an environment of uncertainty for the industry about their responsibilities and possible liabilities. Definitively this is not a good environment for the development of any kind of business, mainly a business transaction so delicate and complex as investing in derivatives.

3.4 *Banking rules*

Not following its traditional approach to investor protection, what have not been a concern of banking regulators, the Office of the Comptroller of the Currency (OCC) enacted in 1993 Banking Circular BC-277,[44] that requires

(41) Russo & Vinciguerra, at 1505 app. "The rule would have required futures commission merchants (FCMs)" — who are roughly equivalent to securities broker-dealers — to assess whether a futures contract was suitable for a customer in light of his financial status and trading objectives. The futures industry objected on the grounds that this type of case-by-case analysis was better suited to the securities industry than to futures trading, as all futures trading is inherently and similarly risky. The industry concluded that any appropriateness evaluation should be made before beginning futures trading altogether, rather than with each transaction. See id. In rejecting the proposed rule, however, the CFTC confused matters somewhat by stating that the principles underlying the suitability rule were already part of the Commodities Exchange Act's antifraud provision. It quickly retreated from this position, although for a time administrative law judges nonetheless tried to infer a suitability rule. Jerry W. Markham & Kyra K. Bergin, "Customer Rights Under the Commodity Exchange Act", 37 Vand. L. Rev. 1299, 1307 (1984).

(42) To better understand the subject see Jerry W. Markham, "Fiduciary Duties Under the Commodity Exchange Act", 68 Notre Dame L. Rev. 199 (1992).

(43) Gibson Greetings, "Inc. v. Bankers Trust Co.", N.° C-1-94-620 (S. D. Ohio Sept. 12, 1994). In its suit against Bankers Trust, Gibson Greetings alleged, among other claims, that the bank breached its fiduciary duty.

(44) "Risk Management of Financial Derivatives", OCC Banking Circular BC-277, Fed. Banking L. Rep. (CCH) P 58, 717, at 36, 462 (Oct. 27, 1993).

bank's officers to identify whether a proposed derivatives' transaction is appropriate for its buyer. This rule, called as "appropriateness" standard, imposes to national[45] banks' requirements that is very close to requirements instituted by securities suitability requirements.[46] In determining the appropriateness of certain derivative to certain customer, the bank has to analyze the impact of the derivative transaction on the financial condition of that customer and that this customer understands the transaction and the risks it involves. In case that the Bank believes that the derivatives' transaction is inappropriate for a determined client, and if this client, in contrary to the bank's warn, still wants to close the transaction, bank's officers are allowed to proceed with the deal.[47]

In fact, that rule that was primarily designed to prevent banks from being sued from a frustrated customer, and to protect banks from situations which the counterparts are unable to perform its obligations, turned out to be a rule very close to a suitability rule and very effective for customers protection against unsuitable derivatives.[48]

3.5 The written agreement between bankers trust and the federal reserve

In an enforcement action that arose in the wake of the lawsuits by Proctor & Gamble and Gibson Greetings over losses on interest rate swaps sold by Bankers Trust and its subsidiaries, as already mentioned, the Federal Reserve of New York and the determined Bank entered into a formal written agreement.[49] This agreement imposes, besides others things, a client selection requirement that forces Bankers Trust to conduct its business in a manner that reasonably seeks to ensure that each customer has the capability to understand the derivative's transaction it is about to proceed, its conditions and risks of any "leveraged derivatives"[50] transaction. The bank has also to disclose to customers sufficient information for them to understand the nature, terms, conditions, and

(45) As with all OCC activities, it only applies directly to national banks.

(46) "Risk Management of Financial Derivatives: Question and Answers — Re": BC-277, OCC Bulletin 94-31, Fed. Banking L. Rep. (CCH) P 58, 717, at 36,473, 36,478-80 (May 10, 1994). The OCC had difficulties to distinguish the appropriateness standard from a true suitability requirement.

(47) See OCC Bulletin 94-31, at 36,480.

(48) "OCC is Reviewing Derivative Sales Practices of Five Large Multinacionals, Banking Daily (BNA)", Mar. 4, 1995, available in LEXIS, Banking Library, Bnabd File. The OCC has announced that it is investigating the sales practices of five large multinational banks for compliance with the BC-277 appropriateness standar. Although the banks are "substantially complying" with the standard, the OCC apparently wants more details about their operations. Id.

(49) "Signed, Sealed, Economist", Dec. 10, 1994, at 81 and "Saul Hansell, Bankers Trust and U. S. Set Pact on Disclosure of Derivatives' Risk", N. Y. Times, Dec. 6, 1994, at A1. A written agreement is the Federal Reserve's second most powerful enforcement tool; a cease-and-desist order is the most powerful. The use of a written agreement is rather rare against a major commercial bank and might be considered somewhat embarrassing. Unlike memoranda of understanding, a more common sanction, written agreements are made public and can be judicially enforced. However, its sanctions probably cannot be enforced by third parties.

(50) Brett D. Fromson, "Bankers Trust Faces Derivatives Scrutiny", Wash. Post, Dec. 6, 1994, at C1. The agreement governs only "leverage" derivatives transactions, which are extremist volitle. The agreement uses a fairly technical definition of leveraged derivatives transactions. The bank claims that such transactions account for only about five percent of its derivatives activities.

risks of the transaction. Bankers Trust, so, is required to implement sales policies governing new product identification and disclosure and to distribute written term sheets and sensitivity analyses. The bank must additionally develop policies to ensure the reasonable transparency of derivative pricing and valuation for its customers,

3.6 The derivative's industry voluntary standard for the sale of derivatives

Another response, and attempt to find solutions for the derivative's suitability problem are the voluntary standards, that derivatives' industry is generating. There are two efforts in this way.

First we have the Framework for Voluntary Oversight from the Derivatives Policy Group.[51] Essentially it imposes a standard disclosure for the dealers that should, as there suggested, disclosure the risks involving the transaction and clarify the transaction and the relationship between dealer and customer. The framework also suggests that the investment in derivatives is a particular decision of the buyer, and that the dealer should avoid giving opinions.

The other major voluntary effort in the same way is the Wholesale Transactions Code of Conduct.[52] It more or less follows the rational line expressed in the written agreement between the Federal Reserve of New York and Bankers Trust. Says that it party should assume that the other is capable to understand the transaction and make its own free decisions about it. Nevertheless, if one party ("A"), the dealer, realizes that the other party ("B"), does not have the ability to understand the transaction and its risks. Then party A should either not make the transaction, or enter in a written agreement with the parties agreeing that B can rely on the transaction, after providing A with complete information about its financial situation and objectives.[53]

All those several approaches for the problem exposed above are not conclusive suitability rules, nor are these attempts extensive enough to cover all kind of OTC derivatives. They seek solutions for the same problem, but showing different solutions. A general suitability rule for derivatives is needed, however it's far from be a fact. No one of the cases contesting dealer for sale of unsuitable derivatives have imposed penalties for dealers whose only guilty was the sale of that not appropriate derivatives. The breach of fiduciary duty by a mispresentation of the transaction with derivatives, and fraudulent sales practices have been being better bases for succeeding in lawsuits against the dealer who one believed was responsible for her losses, than a pure unsuitability argument.

4. Conclusion

Derivatives may be extremely useful for financial management for those investors who fully understand them. They are not always suitable for the parties that invest in them. Due to their complexity, not always users completely understand the kind of risk that some derivatives may expose them, as proved by the several recent losses' events.

(51) The six firms are Goldman Sachs, Merrill Lynch, CS First Boston, Morgan Stanley, Salomon Brothers, and Lehman Brothers. The SEC and the CFTC also participated in the development of the standards.

(52) Drafted by several industry groups, such as the Emerging Markets Traders Association, the Internacional Swaps & Derivatives Association, the Public Securities Association, and the Securities Industry Association assisted by the Federral Reserve of New York.

(53) Wholesale Transactions Code of Conduct s 4.3.1 (Proposed Draft 1995).

The willingness of the industry and policymakers to find a solution for the problem, together with public pressure for a regulatory response to the several recent immense monetary losses, highlighted the question of who should bear the responsibility for determining whether an investment is suitable or not. That question together with the desire to maintain derivatives' market growing will lead to a uniform derivatives' suitability rule, that can come from common law, from federal statutes as well as from an industry self-regulation. It does not matter from where that suitability rule comes, what matters is that this rule must not impose extreme obligation to the participants of a derivative transaction, that can implicate in exorbitant difficulties for market development. The protection of some kind of investors does not have to take from them all the responsibilities to know in what and why they are proceeding with some investments.

The several existing suitability rules exposed in this paper, may give the guideline lines for the construction for the uniform suitability rule over OTC derivatives. In the securities field, brokers may have a duty to reasonably believe that a recommended investment is suitable for a customer. Nevertheless the nature of the derivatives' market makes simply importing the securities rules impossible. The securities bright-lines rules have a scope that I believe is very appropriate to OTC derivatives. Since most of the current derivatives' users tend to be fairly sophisticated and institucional, with financial capacity to bear monetary losses, I understand that this kind of investors is able to fend for themselves, and so they should be ruled by the rule of caveat emptor. On the other hand, investors without that characteristics should receive protection from statutes when making transactions in the OTC derivative's market.

The simply fact that the occurrence of the recent losses in derivative's transaction is being discussed by all the parties in the derivatives' market is a good sign that a solution will be achieved.