

Protecting the Institutional Investor— Jungle Predator or Shorn Lamb?

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In the latter half of this century, the institutional investor has increasingly become a central player in financial markets. Institutions, such as large commercial firms and pension funds, are often believed to be experienced and “sophisticated” investors. Consequently, institutional investors are generally subject to less regulation with respect to trading activities than are most individual investors.

Many institutions trading in highly complex derivative instruments have recently suffered staggering losses, calling into question the appropriateness of the deregulation. Some institutions claim that they were not able to assess the risk of derivatives and that the banks and other firms who sold them the instruments should be liable for the institutions’ losses.

Professor Markham argues that institutional investors should not be able to take legal action against their brokers, claiming to be unsophisticated investors, while at the same time enjoying the benefits of deregulation solely because of an apparent sophistication. Specifically, Professor Markham proposes a risk disclosure document requirement that would assure that institutions are aware of the risks involved in derivative trading and would inform dealers of the level of sophistication of the institution with which they are dealing. This requirement would preserve the efficiencies of deregulating institutional traders, while encouraging greater institutional care that would result in less litigation and fewer losses.

Introduction	346
I. The Rise of the Institutional Investor	347
A. <i>A New Force Emerges: Evidence</i>	347
B. <i>A New Force Emerges: Causes</i>	350
C. <i>The Regulators Respond: Deregulation and a Two-Track System</i>	353
1. <i>SEC Responses</i>	354
2. <i>CFTC Responses</i>	355
3. <i>The Assumptions Underlying Deregulation</i>	357

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II. The Problem of Unsophisticated Institutional Investors	358
A. <i>The Rising Specter of Financial Losses and Damage Suits</i>	358
1. <i>Recent Evidence of Institutional Losses</i>	358
2. <i>Playing Victim: The Institutions Sue</i>	363
B. <i>The Shortcomings of Current Legal Remedies</i>	368
1. <i>Suitability Requirements</i>	368
2. <i>Reliance Claims</i>	371
3. <i>Breach of Fiduciary Duty</i>	374
C. <i>Deregulation, Responsibility, and Risk</i>	376
III. Tackling the Problem of the Unsophisticated Institution	377
A. <i>Risk Disclosure Statements</i>	377
1. <i>Proposed Form</i>	378
2. <i>Scope of Use</i>	381
3. <i>Effects</i>	381
B. <i>Private Risk Assignment Through Contracts</i>	383
Conclusion	385

Introduction

One of the most striking developments in financial markets during the latter half of this century has been the growing dominance of the institutional investor. The expanding role of large, institutional investors has been accompanied by demands for lessened regulation of these entities, because institutions are said to have the sophistication to protect themselves from fraud and overreaching.¹ Regulators have been receptive to such demands. Consequently, many institutional traders have been freed of the regulatory shackles imposed in markets where the proverbial widows and orphans invest. The result amounts to a virtual two-track regulatory system: one set of rules governs trading by sophisticated institutions, and another more restrictive set of rules governs trading by unsophisticated “retail” customers.

1. For the purposes of this article, the term “institutional investor” encompasses large commercial firms and wealthy and sophisticated individuals that have the ability, or the wherewithal to retain outside advisers, to analyze the risks that may be encountered in dealing with complex investments. As discussed below, the federal securities laws attempt to set objective criteria for identifying institutions and individuals that have such wealth and sophistication. Those criteria include minimum asset, income, and other tests. The regulations of the Commodity Futures Trading Commission take a similar, although somewhat more restrictive, approach. *See infra* part I.C.

Recent events have called into question the appropriateness of this two-track system. Many institutions trading in highly complex over-the-counter derivative instruments have suffered staggering losses. Some of these institutions now claim that they did not have the ability to appreciate the risks of derivative instruments. They further assert that banks or other firms who sold them these sophisticated and often novel instruments did not take into account the institutions' lack of suitability.²

This Article examines the regulatory and legal issues raised by such claims. It proposes some limited measures to better assure that institutions trading in derivative instruments have the requisite expertise to understand the risks involved. These proposals seek to assure that, once an institution accepts the regulatory benefits of institutional status, the derivative dealers with whom it transacts will be protected from after-the-fact claims that the institution lacked knowledge and sophistication.

Part I of the Article traces the growth of the institutional investor and the development of a two-track regulatory system for institutional and retail investors. Part II examines the phenomenon of claims by "unsophisticated" institutions who assert that they were sold unsuitable investments or that they were not otherwise protected from substantial losses. Part III of the Article then proposes some solutions to the dilemma of the unsophisticated institution. Specifically, the Article proposes a risk disclosure document requirement. This requirement would preserve the efficiencies of a two-track regulatory system, while assuring that end users of derivatives are aware of the risks they are facing and that dealers are on notice as to the level of sophistication of the institution with which they are dealing.

I. The Rise of the Institutional Investor

A. *A New Force Emerges: Evidence*

The mix of participants in financial markets has changed dramatically in the latter half of the twentieth century. One of the "most profound developments" in the markets has been the shift in stock ownership from individuals to institutions.³ In the 1950s, individual investors held ninety percent of American equities. Now, just forty years later, institutions control more than half of all stock.⁴

2. See G. Bruce Knecht, *The Lawyer's Turn: Derivatives Are Going Through Crucial Test: A Wave of Lawsuits*, WALL ST. J., Oct. 28, 1994, at A1.

3. NEW YORK STOCK EXCH. & THE WHARTON SCH., *THE POLICY IMPLICATIONS OF STOCK OWNERSHIP PATTERNS* 1 (1993).

4. *Id.*

This "institutionalization" of the financial markets has steadily increased over the decades.⁵ In 1958, institutions held twenty-six percent of outstanding stock.⁶ That figure grew to almost forty percent by 1970.⁷ Block sales accounted for about fifteen percent of trading volume on the New York Stock Exchange in 1970.⁸ By 1986, their share of trading volume had grown to fifty percent.⁹ In 1990, institutions held thirty-nine percent of all over-the-counter stocks and eighty-seven percent of privately placed securities.¹⁰

Naturally, the drop in individual ownership was equally dramatic. Between 1980 and 1990, individual investors' share of all outstanding stock dropped by one fourth.¹¹ Direct stock ownership by individuals dropped from approximately eighty-four percent of outstanding holdings in 1965 to about fifty-three percent in 1991.¹² By 1989, individuals were net sellers of stock at the rate of about 3.5 million shares per day.¹³

The shift in ownership patterns is reflected by the growth of financial colossuses. In 1994, pension funds held securities valued in excess of \$2 trillion,¹⁴ insurance company holdings exceeded \$1 trillion, and mutual

5. DIVISION OF MKT. REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS 6 (1994) [hereinafter MARKET 2000.] The growth of the institutional investor has given rise to concern about the development of a three-tiered market composed of (1) large institutions, (2) medium-sized institutions and wealthy individuals, and (3) small retail customers. OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS: U.S. SECURITIES MARKETS AND INFORMATION TECHNOLOGY 7 (1990) [hereinafter ELECTRONIC BULLS AND BEARS].

6. SEC, INSTITUTIONAL INVESTOR STUDY REPORT, pt. 1, at 9 (1971) [hereinafter INSTITUTIONAL INVESTOR STUDY].

7. *Id.* Between 1960 and 1980, the percentage of New York Stock Exchange stock held by institutions increased from 17.2% to 35.4%. Institutions accounted for over seventy percent of New York Stock Exchange volume by 1980. Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 114 (1984).

8. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS II-16 (1988) [hereinafter MARKET MECHANISMS REPORT]. Block trades are transactions involving 10,000 or more shares or which are valued at \$200,000 or more. Seligman, *supra* note 7, at 138.

9. MARKET MECHANISMS REPORT, *supra* note 8. In 1965, block trades accounted for only 3.1% of volume. Seligman, *supra* note 7.

10. ELECTRONIC BULLS AND BEARS, *supra* note 5, at 6 n.8.

11. William Power, *Small Investor Continues to Give up Control of Stock*, WALL ST. J., May 11, 1992, at C1.

12. *Id.*

13. ELECTRONIC BULLS AND BEARS, *supra* note 5, at 28. Total trading volume in 1989 was about 160 million shares a day. *Id.* at 8. Between 1955 and 1961 mutual fund holdings increased from some \$1 billion to more than \$20 billion. JOEL SELIGMAN, TRANSFORMATION OF WALL STREET 277 (1982)

14. The pension funds alone hold investments that constitute about one quarter of the stock and bond markets. Jim Saxton, *A Raid on America's Pension Funds*, WALL ST. J., Sept. 29, 1994, at A12.

fund securities holdings were valued at over \$800 billion.¹⁵ Mutual funds' holdings increased even more dramatically in the early 1990s as interest rates dropped sharply.¹⁶ Their assets expanded to over \$1.8 trillion by August of 1993. This helped push the Dow Jones Industrial Average to previously undreamed-of levels.¹⁷

Surveys of the futures exchanges also indicate significant change in the nature of those markets. The futures markets were largely devoted to agricultural commodities before the 1980s. At that time, the so-called "financial" futures began to intrude into these markets. Financial futures now account for about eighty-three percent of the trading volume on the Chicago Board of Trade, up from some forty percent in 1983, and ninety-

15. ELECTRONIC BULLS AND BEARS, *supra* note 5, at 6.

16. The modern day mutual fund is the direct descendant of the investment trusts that grew rapidly in number during the 1920s. In 1921, there were just forty such investment trusts. That number swelled to over 700 by 1929. At that time, investment trusts held over \$7 billion in assets, paying enormous fees to their organizers. See TOWNSEND HOOPEES & DOUGLAS BRINKLEY, *DRIVEN PATRIOT: THE LIFE AND TIMES OF JAMES FORRESTAL* 98 (1992). The investment trust funds suffered severe losses when the stock market crashed in 1929. The most highly publicized losses were in the Goldman, Sachs Trading Corporation. After the crash, its stock traded at less than \$2, down from over \$100 in December 1928. S. REP. NO. 1455, 73d Cong., 2d Sess. 339 (1934) ("A veritable epidemic of investment trusts afflicted the Nation."). The investment trusts were the subject of a number of abuses in the 1920s, including fraudulent and misleading profit claims, excessive sales charges, payments of capital to investors in order to improve returns and attract new investors, investments in worthless securities and in the shares of other trusts in order to boost their prices, and the outright conversion of customer funds. See generally TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS: THE INVESTMENT COMPANY ACT AND THE INVESTMENT ADVISERS ACT* (1978).

The investment trust in the United States was modeled after English and Scottish finance trusts that were organized as early as 1865. *Id.* at 334. Forerunners of the modern mutual fund have also been traced to the Société Générale de Belgique, founded in 1822. Max Rottersman & Jason Zweig, *An Early History of Mutual Funds*, FRIENDS OF FIN. HIST., Spring 1994, at 12.

For wealthy individuals, trust funds were another form of institutional trading. These trusts were often managed by banks or trust companies. In 1929, more than a thousand millionaires were using trusts. By 1975, bank trust departments were managing over \$400 billion in assets. Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 NOTRE DAME L. REV. 199, 209 (1992).

17. *Finance, Up and Up Until It Popped*, ECONOMIST, Aug. 14, 1993, at 73. The higher rates of return available in the securities markets from post-war growth attracted the mutual funds. That growth also attracted investors who wanted the expert investment skills and diversification that were available from mutual funds. This increased the demand for stock as the mutual funds expanded and further increased prices. See INSTITUTIONAL INVESTOR STUDY, *supra* note 6, at 222. Individual investors still play important roles through their indirect stock ownership interests in mutual funds, pension funds and insurance company portfolios. The number of individual shareholder accounts and their absolute volume continue to increase, even as their share of the market declines. MARKET 2000, *supra* note 5, at II-1, II-2.

seven percent of the trading volume on the Chicago Mercantile Exchange.¹⁸

This substantial product change in the futures markets reflects an evolution in the makeup of the participants in the futures markets. A study conducted in the 1930s found that many traders in the commodity futures markets were unsophisticated individuals, including large numbers of housewives and unemployed persons.¹⁹ Forty years later, another survey disclosed that most small non-professional futures traders generally were well educated, were over forty-five years of age, and earned over ten thousand dollars per year; they were mostly lawyers, doctors, dentists, and business professionals.²⁰ A 1978 survey of traders in financial futures found that these markets were being dominated by professionals and institutions.²¹ A 1984 survey of futures traders also showed that individual non-commercial traders held less than one third of the outstanding financial futures contracts.²² The basic trend toward institutional concentration in both securities and derivatives markets has been steady and dramatic.

B. *A New Force Emerges: Causes*

Many factors have contributed to the growth of institutional investing in the securities and futures markets. The growth of private and governmental pension funds has played a significant role. Another contributing factor has been the demand for diversification and expertise in trading as the markets have grown more complex. Those factors led to the growth of mutual funds, as did the almost continual rise in stock prices since World War II.²³ The increased complexity of the markets

18. Steven E. Levingston, *Rift Grows Between Factions at CBOT*, WALL ST. J., Sept. 26, 1994, at C1.

19. JERRY W. MARKHAM, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* 26-27 (1987).

20. MARK J. POWERS, *GETTING STARTED IN COMMODITY FUTURES TRADING* 10-11 (4th ed. 1983).

21. See RONALD B. HOBSON, *CFTC, FUTURES TRADING IN FINANCIAL INSTRUMENTS* (1978).

22. FEDERAL RESERVE BD. ET AL., *A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS* IV-7 (1984).

23. In 1971, the SEC conducted a massive study of institutional traders. The study concluded, "The shift of institutions into stocks over the postwar period does not lend itself to any complex econometric explanation. Rates of return on equity have been much above bond rates throughout the period. The shift to stocks appears a belated and long process of adaptation to these circumstances." *INSTITUTIONAL INVESTOR STUDY*, *supra* note 6, at 222. This report also noted that "[i]nstitutions appear to have changed their expectations regarding the future return on equity investment in response to the high return earned by a segment

and the willingness of institutions to engage in more speculative activities have also led to the development of hedge funds that seek to take advantage of leveraged opportunities.²⁴

Other legal factors have also spurred the rise of the institutional investor. The “prudent man rule” for trustees has been modified to allow increased participation in equity markets.²⁵ The Department of Labor’s decision to ease the restrictions on pension fund investments under ERISA also allowed greater flexibility in investment decisions.²⁶ These legal changes freed institutions from investing in only a limited list of investment devices, setting the stage for expansion in investment portfolios by the growing number of pension funds, insurance companies, mutual funds, and other institutions.

Theoretical developments also contributed: the advent of modern portfolio theory led investors to seek increasingly diversified investment portfolios.²⁷ Under this theory, an investment portfolio is to be judged by its overall performance.²⁸ This has led to the increasing use of “passive” institutional investment strategies that track market moves through diversified portfolios.²⁹ Modern portfolio theory also induced experimentation in the world of leveraged investments, including futures

of the mutual fund industry.” *Id.* at 223. Thus the higher rates of return available in the securities markets from post-war growth initially attracted the mutual funds. As post-war growth continued, it enhanced the value of mutual funds and increased demand for stock as the funds expanded. The growth of the mutual funds further increased the demand for stock and further elevated stock prices.

24. “The term ‘hedge fund’ generally refers to a private fund involving fewer than 100 investors that can engage in more aggressive forms of trading, such as margin buying, short selling, day trading, and speculative use of derivatives.” MARKET 2000, *supra* note 5, at II-3.

25. Bevis Longstreth, *Fiduciaries, Capital Markets and Regulation: The Current Challenge*, 7 ANN. REV. BANKING L. 237 (1988). The prudent man rule limited trustees to investments that only a “prudent” man would use for funds of the beneficiaries of a trust. This standard was restrictive and did not permit trustees to engage in speculative or risky investment strategies. *See generally* Joseph V. Rizzi, *Trustee Investment Powers: Imprudent Application of the Prudent Man Rule*, 50 NOTRE DAME L. REV. 519, 520 (1975).

26. *See generally* James D. Hutchinson, *The Prudent Man Rule Under ERISA*, 22 VILL. L. REV. 15 (1976-77); Longstreth, *supra* note 25, at 239-40.

27. Under modern portfolio theory, no adviser or stock picker can outperform the market. The best an adviser can do is diversify portfolios to reflect overall market changes. *See generally* BEVIS LONGSTRETH, *MODERN INVESTMENT AND MANAGEMENT AND THE PRUDENT MAN RULE* (1986).

28. *Id.* ERISA regulations “reflect most dramatically the influence of portfolio theory because they specifically state that the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the entire portfolio.” Longstreth, *supra* note 25, at 239-40.

29. MARKET 2000, *supra* note 5, at II-3.

and options.³⁰ Futures markets have been particularly attractive because they offer broadly indexed contracts at relatively low transaction costs.³¹ Institutions soon found indexed instruments to be to their liking, and now dominate those markets. The increased participation of institutions in the futures and options markets has spurred the development of even more complex instruments to accommodate their needs and desires. The steadily growing over-the-counter derivatives market is largely an institutional market.³²

The derivatives market may be described more accurately as a "hybrid" instrument market. This is because many of these instruments have elements of futures, options, and conventional securities. For example, a hybrid bond may be offered at a discount from its maturity. Coupled with the bond is a "kicker" that will pay an amount over the maturity value if the price of a particular commodity or index of commodities rises above a specific level. This allows the bond purchaser to profit from those price changes and perhaps have a hedge against inflation that would be unavailable in a conventional bond. The purchaser will pay an implied premium by receiving a smaller discount on the bond than would otherwise be available, thus allowing the issuer to reduce financing costs. This makes the arrangement look very much like a bond with an attached option on the specified commodity or index.³³

Another derivative instrument is the swap, which comes in many forms. In one variety, a party with a fixed-rate loan swaps its loan payments with another institution that has a variable-rate obligation. This effectively allows the first institution to convert its fixed-rate obligation into a floating-rate obligation, thereby reducing its risk exposure to decreases in interest rates. The second institution may anticipate an

30. Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 90 (1990).

31. MARKET 2000, *supra* note 5, at II-3. See generally MARKET MECHANISMS REPORT, *supra* note 8; NICHOLAS DEB. KATZENBACH, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES (1987)

32. For discussion of the growth and development of the over-the-counter derivatives market, see David J. Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 VAND. L. REV. 1599 (1986); Jerry W. Markham, "Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 101 (1994) [hereinafter Markham, "Confederate Bonds"]; Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call For Alternatives*, 1990 COLUM. BUS. L. REV. 1 [hereinafter Markham, *Regulation of Hybrid Instruments*]. For discussion of the regulation of over-the-counter derivative instruments, see Sheila C. Bair & Susan Milligan, *United States: U.S. Financial Regulation of OTC Derivatives*, 1994 FUTURES & DERIVATIVES L. REV. 1.

33. Markham, *Regulation of Hybrid Instruments*, *supra* note 32.

increase in interest rates or have other needs that make it desirable to transform its obligation from a variable to a fixed rate loan.³⁴

The over-the-counter derivatives market is now composed of over twelve hundred kinds of derivatives, including such exotica as “death-backed bonds,” “worthless warrants,” “exploding options,” “inverse floaters,” and “heaven and hell bonds.”³⁵ The notional amount of the outstanding derivative instruments in that market is estimated to be between \$12 trillion³⁶ and \$35 trillion.³⁷

C. *The Regulators Respond: Deregulation and a Two-Track System*

The growing dominance of the institutional investor, and of markets in derivatives tailored to its needs, soon led to demand for reduced regulation.³⁸ The institutions wanted greater freedom in their investment

34. For a discussion of the swaps market, see Schuyler K. Henderson, *An Analysis of Interest Rate and Currency Swaps*, 11 N.C. J. INT'L L. & COMM. REG. 497 (1986); Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of the Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989); Lauren S. Klett, Comment, *Oil-Price Swaps: Should These Innovative Financial Instruments Be Subject to Regulation by the Commodity Futures Trading Commission or the Securities and Exchange Commission?*, 93 DICK. L. REV. 367 (1989).

35. Albert R. Karr, *Bank Regulator Signals Move on Derivatives*, WALL ST. J., Apr. 21, 1994, at A3; Antonia Sharpe & Laurie Morse, *Survey of Derivatives*, FIN. TIMES, Oct. 20, 1993, at XII; Elayne Sheridan, *FCMs Capitalize on OTC Business*, FUTURES INDUSTRY, Nov.-Dec. 1993, at 26, 29. Innovation continues in the development of new derivative instruments. See, e.g., Michael Santoli, *Some Investment Banks Create Hybrids*, WALL ST. J., Nov. 7, 1994, at A9 (describing equity linked notes); Greg Steinmetz, *A Derivative Tied to Snapple Shares Takes Sharp Drop*, WALL ST. J., Nov. 3, 1994, at A3 (discussing “ELKS,” which are bonds with return linked to both price of a common stock and an interest rate); David Wighton, *Bidder Opts for Derivative Contract*, FIN. TIMES, Dec. 20, 1994, at 22 (describing difference from trading in stocks).

36. Steven Lipin, *GAO Study Seeking Stricter Controls on Derivatives Draws Industry Fire*, WALL ST. J., May 19, 1994, at B7.

37. Randall Smith & Steven Lipin, *Beleaguered Giant: As Derivatives Losses Rise, Industry Fights to Avert Regulation*, WALL ST. J., Aug. 24, 1994, at A1. The “notional amount” of a derivatives contract refers to the value of the commodity or instrument underlying the derivatives contract. This value may not reflect the actual risk exposure or payments required under a derivatives contract, however, because delivery of the underlying commodity rarely occurs. The parties usually make payments based on price or interest rate changes that occur in the underlying commodity or obligation. *Id.*

38. The growth of the institutional investor has also given rise to a debate as to whether institutional investors should be passive investors or active shareholders who can monitor and make demands on corporate management. See generally Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445 (1991).

decisions, and they wanted to be free of restrictive regulations that had been adopted to protect unsophisticated investors such as those who had been so badly damaged by the Stock Market Crash of 1929. The institutions particularly chafed at being shackled with the restrictive regulations of the Securities and Exchange Commission (SEC), nearly all of which had been adopted to protect the small investor. Clearly, it was argued, the institutions were too sophisticated to be regulated like the typical retail customer of a broker-dealer.

1. *SEC Responses*

Regulators have responded favorably to requests for the removal of restrictive regulations on institutions. The SEC has been particularly supportive of the development of a two track regulatory system—one for institutional investors and one for unsophisticated investors. For example, it has allowed the development of the so-called private placement of securities to institutional investors and wealthy individuals, without requiring compliance with many of the cumbersome registration requirements imposed on public offerings. The SEC's Regulation D exempts issuers from many of the registration requirements of the federal securities laws when they place their securities with "accredited" investors.³⁹ Accredited investors are defined to include banks, savings and loans, pension funds, and tax exempt organizations and trusts with assets in excess of \$5 million. Accredited investors may also include natural persons whose net worth exceeds \$1 million or who have had income in excess of \$200,000 in each of the two preceding years.⁴⁰ When accredited investors are the only participants in a securities issue, the amount of disclosure required is greatly reduced. In fact, there are no specific disclosures required.⁴¹ The private placement market has grown rapidly and is a popular investment medium for institutions. In 1993

39. 17 C.F.R. §§ 230.501-230.506 (1993). The private placement exception may also be used to exempt institutional transactions. 15 U.S.C. § 77d(2) (1988). The SEC also exempts distributions of certain foreign securities from underwriting restrictions when the securities are being sold to institutional investors. 17 C.F.R. 240.10b-6(i) (1993).

40. See 17 C.F.R. § 230.215 (1993). For a discussion of the operation of Regulation D and related exemptions, see THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.17 (Student Ed. 1990).

41. See HAZEN, *supra* note 40, at § 4.17. SEC Rule 505, for example, allows offerings of up to 5 million dollars during any twelve month period to any number of accredited investors and up to thirty-five non-accredited investors, provided that there are no general solicitations or advertising. 17 C.F.R. § 230.505 (1993). Rule 506 is similar to Rule 505, but it allows for offerings of unlimited size, provided that the purchasers are all accredited investors or that the non-accredited investors or their advisers are sufficiently sophisticated to understand the terms of the offering. 17 C.F.R. § 230.506 (1993).

alone, almost \$220 billion in debt and equity was raised through private placements.⁴²

The SEC's efforts have resulted in the development of an institutional market in the securities industry in which the participants are viewed as having the resources and sophistication to protect themselves when assessing the risks of their investments. Many institutions have the bargaining power to demand instruments tailored to their particular needs and to receive customized investment opportunities. A public shareholder has no such power and often lacks the ability to assess the risks of the investment without the analysis and advice of a broker-dealer or investment adviser.

2. CFTC Responses

Institutions are accorded special treatment in the futures markets. Commercial traders engaged in "hedging" operations are not subject to the "speculative limits" imposed by the Commodity Futures Trading Commission (CFTC) on speculators. Speculative limits restrict the ability of individuals to engage in large scale transactions in heavily leveraged futures instruments.⁴³ The CFTC has also relieved commodity pool operators and commodity trading advisers from certain disclosure requirements when their customers qualify as large institutions.⁴⁴

Institutional investors in commodity futures have benefited in other ways from CFTC and Congressional actions. The Commodity Exchange Act contains a provision that requires all futures contracts to be traded on

42. NATIONAL ASS'N OF SEC. DEALERS, *SECURITIES REGULATION IN THE UNITED STATES 18-19* (1994). A factor contributing to the development of institutional hedge funds is the exclusion in the Investment Company Act of 1940 for investment companies with less than one hundred security holders. 15 U.S.C. § 80a-3(c)(1) (1988). Such hedge funds are essentially mutual funds with less than one hundred participants.

43. Traders are exempt from speculative limits where they are engaged in "bona fide" hedging transactions as defined in CFTC regulations. See 7 U.S.C. § 6a (1988) (granting CFTC powers to curb excessive speculation); 17 C.F.R. § 1.3(z) (1994) (defining bona fide hedging transactions). See generally *CFTC v. Hunt*, 591 F.2d 1211 (7th Cir.), cert. denied, 442 U.S. 921 (1978) (validating CFTC's speculative trading limit on soybean futures contracts).

Speculative traders had long plagued the futures markets and raised concerns with respect to price manipulations. See Jerry W. Markham, *Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 YALE J. ON REG. 281 (1991); Wendy C. Perdue, *Manipulation of Futures Markets: Redefining the Offense*, 56 FORDHAM L. REV. 345 (1987).

44. 17 C.F.R. § 4.7 (1994). These exemptions apply, for example, to persons with a portfolio of \$1 million or more, banks, insurance companies, certain employee benefit plans with assets of five million dollars or more, and individuals with a net worth of \$1 million or more. *Id.*

an exchange that is licensed by the CFTC as a "contract market."⁴⁵ The CFTC also requires most commodity options contracts to be traded on contract markets.⁴⁶ This could have precluded the trading of many over-the-counter derivatives because they often contain elements of futures and options. After struggling for some time with the issue of what derivatives would constitute futures or options, however, the CFTC adopted a set of rules and interpretations that allowed for a wide range of over-the-counter derivatives to be traded by institutions, including swaps.⁴⁷

Nevertheless, uncertainty remained over the CFTC's ability to exempt institutions or other investors from the exchange trading requirement. In the absence of an exemption, the institutions' customized derivative products could not have been traded even on an exchange because they did not fit the standardized format then required for exchange trading.⁴⁸ The Futures Trading Practices Act of 1992⁴⁹ was enacted to provide specific authorization to the CFTC to exempt institutions from the exchange trading requirement to the extent that they engage in swaps and certain other over-the-counter obligations.⁵⁰ The CFTC later adopted regulations that identified the institutions and instruments that would be exempt from the exchange trading requirement.⁵¹ Among the entities exempted were banks, trust companies, savings associations, credit unions, governmental entities, and insurance companies.⁵²

The over-the-counter (OTC) derivatives markets grew rapidly as a result of the CFTC's determination to exempt OTC derivative instruments

45. 7 U.S.C. § 6 (1988). See generally Jerry W. Markham, *The Commodity Exchange Monopoly—Reform Is Needed*, 48 WASH. & LEE L. REV. 977 (1991).

46. 17 C.F.R. § 33.2 (1994). Options contracts between institutions for "commercial" purposes were exempted from this requirement. 17 C.F.R. § 32.12 (1994).

47. See Jerry W. Markham, *Regulation of Derivative Instruments Under the Commodity Exchange Act: A Call for Alternatives*, 1990 COLUM. BUS. L. REV. 1, 27-28.

48. The popularity of the over-the-counter derivatives market is due in part to the fact that transactions can be customized for institutional investors. By contrast, futures and options traded on contract markets are standardized in their terms.

49. Pub. L. No. 102-546, 106 Stat. 3590 (1993).

50. Institutions sought to assure that CFTC regulations were not applied to those transactions. See generally Mark D. Young & William L. Stein, *Swap Transactions Under the Commodity Exchange Act: Is Congressional Action Needed?*, 76 GEO. L. REV. 1917 (1988).

51. 17 C.F.R. § 35.2 (1994). See also John Lindholm, *Financial Innovation and Derivatives Regulation—Minimizing Swap Credit Risk Under Title V of the Futures Trading Practices Act of 1992*, 1994 COLUM. BUS. L. REV. 73.

52. 17 C.F.R. § 35.1 (1994).

from the exchange trading requirement.⁵³ The swaps market alone is estimated to have a notional value in excess of four trillion dollars.⁵⁴

Institutions engaging in interbank currency and certain other financial transactions are also exempted from the requirements of the Commodity Exchange Act (CEA) by the so-called Treasury Amendment added to the CEA in 1974.⁵⁵ The foreign exchange market is one of the world's largest financial markets.⁵⁶ Institutions trading currency in that market are freed from many of the restrictive regulations imposed in markets where small, unsophisticated customers are allowed to trade.⁵⁷

3. *The Assumptions Underlying Deregulation*

Several assumptions underlie regulators' decisions to exempt institutions from regulatory requirements. One basic assumption is that regulation, in terms of its sheer cost in any particular transaction as well as its more general effects on market competition and efficiency, is expensive and therefore needs to be fully justified. The SEC requirements

53. The CFTC is now rethinking this exemption and may narrow its application, while adopting an antifraud rule for exempted transactions. See Jeffrey Taylor & Mark H. Anderson, *CFTC to Reconsider Exemption It Gave to Off-Exchange Derivatives Dealers*, WALL ST. J., Oct. 25, 1994, at C19.

54. William T. Maitland & Jerry W. Markham, *CFTC Rules to Provide Legal Certainty for OTC Products*, FUTURES INDUSTRY MAG., Nov.-Dec. 1992, at 20, 22. Institutions sought legal certainty to assure that CFTC regulations were not applied to those transactions. See generally Young & Stein, *supra* note 50.

55. 7 U.S.C. § 2 (1988). The Treasury Amendment provides that nothing in the Commodity Exchange Act:

shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, re-sales of installment loan contracts, re-purchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sales thereof for future delivery conducted on a board of trade.

Uncertainty concerning the scope of this amendment has led to much litigation and confusion. The CFTC's position is that the amendment applies only to institutions or highly sophisticated and wealthy individuals. See Markham, "*Confederate Bonds*," *supra* note 32, at 123-24. See generally *CFTC v. Standard Forex, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,063 (E.D.N.Y. 1993).

56. Daily trading volume in the interbank currency market is estimated to exceed one trillion dollars per day. *Foreign Exchange Unsettling*, ECONOMIST, May 7, 1994, at 88.

57. Wealthy individuals may be treated like institutions when they trade in the interbank currency market. See, e.g., *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966, 977 (4th Cir. 1994). Compare *CFTC v. American Board of Trade*, 803 F.2d 1242 (2d Cir. 1986) (holding Treasury Amendment exception inapplicable and granting injunction to stop sale of options contracts involving foreign currency) with *CFTC v. Frankwell Bullion Ltd.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,222 (N.D. Cal. 1994) (denying CFTC injunction to stop sale of foreign currency contracts).

that mandate filings of a prospectus and detailed disclosures are expensive to comply with and result in delays in awaiting review by the SEC staff. These expenses and delays should be eliminated if the investor does not need the protection that the disclosure regime is intended to provide.

The SEC assumes that commercial institutions and wealthy and sophisticated investors can determine for themselves what information is needed before making an investment decision. Institutions probably have the bargaining power to demand the information they need from issuers or underwriters. The same is not true of small retail customers. These small investors arguably need the protection of the SEC's prospectus requirements, which guarantee thorough disclosure.

Another perceived difference between institutions and retail customers is that institutions are already better protected by diversification. If a particular investment fails, the overall damage to the diversified investor should not be fatal. Most retail customers do not have sufficient assets to diversify their holdings in such a manner, except through their investments in such institutions as mutual funds.

The exemptions available for institutions under the CFTC's regulatory structure are no less justified than those adopted in the securities industry. Unless exempted, derivative instruments with futures elements must be traded on an exchange designated as a contract market.⁵⁸ The assumptions made in exempting institutions trading derivatives are that such transactions are desirable, that the derivatives market cannot function efficiently in an exchange trading environment, and that large institutions do not need the policing that is available on a regulated exchange.

II. The Problem of Unsophisticated Institutional Investors

A. *The Rising Specter of Financial Losses and Damage Suits*

1. *Recent Evidence of Institutional Losses*

The ascendance of the institutional investor was spurred by the deregulation of institutional trading activities. Events were to demonstrate, however, that institutions do not always have the ability to protect themselves from speculative investment losses. Like other investors, institutions will make and lose money. Their size and expertise do not guarantee that their investments will always be profitable. Indeed, institutional investors have established, quite conclusively, that they can

58. 7 U.S.C. § 6 (1988).

seem as naive in their investments in derivative instruments as a proverbial widow or orphan.⁵⁹

59. The savings and loan crisis has already shown beyond peradventure that institutions do not always have the wherewithal and sophistication to analyze and assess investment risks. Although some of the failed thrifts were small operations, many others were of a sufficient scale such that one would have presumed them capable of analyzing and dealing with investment risk in every form. Yet their deregulation resulted in a debacle in which hundreds of billions of dollars of government funds have been expended in order to rescue depositors from the naivety, foolishness, and even criminality of officers and directors of these institutions. *See generally* S. REP. NO. 19, 101st Cong., 1st Sess. (1989); H.R. REP. No. 54, 101st Cong., 1st Sess. (1989); *Administration's Plan to Resolve the Savings and Loan Crisis: Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. (1989); MICHAEL BINSTEIN & CHARLES BOWDEN, CHARLES KEATING AND THE MISSING BILLIONS (1992); Lissa Broome, *Private Market Solutions to the Savings and Loan Crisis: Bank Holding Company Acquisitions of Savings Associations*, 59 FORDHAM L. REV. 111 (1991); Daniel B. Gail & Joseph J. Norton, *A Decade's Journey From "Deregulation" to "Supervisory Regulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1103 (1990); Robert A. Wittie & Rebecca H. Laird, *The Financial Institutions Reform, Recovery, and Enforcement Act of 1989: An Overview*, 44 CONSUMER FIN. L.Q. REP. 83 (1991).

The repo crises of the 1980s involved institutional investors and raised considerable doubts as to their sophistication. A repurchase agreement ("repo") is simply an agreement to sell securities with a commitment to repurchase them at a specified future date. A reverse repurchase agreement is an agreement to buy and later resell the same securities. SEC, THE USE OF REPURCHASE AGREEMENTS BY BROKER-DEALERS (1987). Repos generally involve United States government securities and are used for short term financing purposes. At one point, they were "the most important financing vehicle for the broker-dealer industry." *Id.* at 2-3. The dollar amount of repo transactions grew from \$14.8 billion in 1977 to almost \$200 billion in 1986. *Id.* at 3. In the seven years prior to 1985, however, there were failures of government bond dealers that resulted in losses of nearly \$1 billion. Most of those losses were the result of repo transactions in which the securities were not returned or where other abuses occurred. SEC, REGULATION OF THE GOVERNMENT SECURITIES MARKET: REPORT BY THE SECURITIES AND EXCHANGE COMMISSION TO THE HOUSE SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FINANCE OF THE COMMITTEE ON ENERGY AND COMMERCE 8 (1985).

Failed merger transactions and soured junk bond deals in the securities industry, to mention two notable problem areas, involved institutions that neither understood nor appreciated the risks of those transactions. *See generally* GEORGE ANDERS, MERCHANTS OF DEBT (1992); CONNIE BRUCK, THE PREDATOR'S BALL: THE JUNK-BOND RAIDERS AND THE MAN WHO STALKED THEM (1988); BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1990); JESSE KORNBLUTH, HIGHLY CONFIDENT, THE CRIME AND PUNISHMENT OF MICHAEL MILKEN (1992); RICHARD PHALON, THE TAKEOVER BARONS OF WALL STREET: INSIDE THE BILLION-DOLLAR MERGER GAME (1981); ROY C. SMITH, THE MONEY WARS, THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980S (1990); DAN G. STONE, APRIL FOOLS, AN INSIDER'S ACCOUNT OF THE RISE AND COLLAPSE OF DREXEL BURNHAM (1990).

A study of pension funds by two anthropologists also raises some serious questions as to the true sophistication of those institutions. Among other things, the authors concluded that pension fund managers seemed to be preoccupied in their decision making with avoiding blame when things go wrong and with managing personal relationships, rather than with critical investment analysis. WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE & FOLLY,

To cite the most extreme example, the government of Orange County, California had to declare bankruptcy after losing more than one billion dollars through investments in derivative instruments.⁶⁰ Orange County's brokers are now facing claims that they should not have recommended these transactions, even though the County's actual investment decisions were handled by its own treasurer.⁶¹ The Orange County treasurer was an accomplished and experienced manager who had previously garnered large returns for the County through equally complex transactions.⁶²

Orange County enjoyed the gains from its prior trading, but now claims victim status after being forced to confront certain fundamental facts that every investor, whether small or large, should know: markets go up and down; no one can consistently beat the market; reward is a function of risk—the greater the potential return, the greater the risk of loss.⁶³ Not all of the facts are public, but it appears that the County

THE WEALTH & POWER OF INSTITUTIONAL INVESTING 228 (1992).

60. See, e.g., *Bitter Fruit, Orange County, Mired in Investment Mess, Files for Bankruptcy*, WALL ST. J., Dec. 7, 1994, at A1; Frederick Rose & Andy Pasztor, *Orange County Expects to Maintain Public Services*, WALL ST. J., Dec. 8, 1994, at A3; Michael Siconolfi & Anita Raghavan, *Wall Street Races to Sell Collateral*, WALL ST. J., Dec. 8, 1994, at A13;

61. *American Municipalities, Merrill Lynched*, ECONOMIST, Dec. 17, 1994, at 76; Dominic Bencivenga, *Municipal Bankruptcy, Orange County Case Tests Reach of Chapter 9*, N.Y. L.J., Dec. 15, 1994, at 5 (class action suits filed against Orange County's broker); G. Bruce Knecht, *Merrill Lynch's Role as Broker to Fund May Expose it to Liability, Lawyers Say*, WALL ST. J., Dec. 8, 1994, at A13; Sarah Lubman & John Emshwiller, *Before the Fall, Hubris and Ambition in Orange County: Robert Citron's Story*, WALL ST. J., Jan. 18, 1995, at A1; Andy Pasztor & Lynn K. Adler, *Orange County Budget Shortfall is Put at \$172 Million over Next Six Months*, WALL ST. J., Jan. 5, 1995, at A4; Andy Pasztor & Laura Jereski, *Orange County Sues Merrill for \$3 Billion*, WALL ST. J., Jan. 13, 1995, at A3; Jeffrey Taylor, *Behind the Throne, Hard-Charging Broker Draws the Spotlight in Orange County Mess*, WALL ST. J., Dec. 12, 1994, at A1.

62. See *The Culprits of Orange County*, FORTUNE, Mar. 30, 1995, at 58.

63. See generally Karen Damato, *Muni-Bond Investors, Shaken by Debacle in Orange County Calif., Raise Questions*, WALL ST. J., Dec. 15, 1994, at C1; Sallie Hofmeister, *Many Questions, But Too Late*, N.Y. TIMES, Dec. 6, 1994, at C1; Sallie Hofmeister, *Fund Head Resigns in California*, N.Y. TIMES, Dec. 6, 1994, at C1; Laura Jereski & Thomas T. Vogel, Jr., *Orange County Borrowed \$1 Billion Even As Its Investment Losses Piled Up*, WALL ST. J., Dec. 5, 1994, at A3; G. Bruce Knecht, *Derivatives Lead to Huge Loss in Public Fund*, WALL ST. J., Dec. 2, 1994, at A3; Floyd Norris, *In Orange County, Strategies Sour*, N.Y. TIMES, Dec. 8, 1994, at C1; Andy Pasztor, *Orange County Reduces Loss Estimate to \$1.69 Billion From \$2.02 Billion*, WALL ST. J., Jan. 19, 1995, at A4; Frederick Rose, *Orange County Needs to Sell Assets of \$5.45 Billion*, WALL ST. J., Dec. 23, 1994, at A4; Rhonda L. Rundle & David J. Jefferson, *Orange County Officer Quits After Fund He Managed Lost \$1.5 Billion of Value*, WALL ST. J., Dec. 6, 1994, at A1; Jeffrey Taylor, *SEC Probed Orange County Investments Just Months Before the Fund's Collapse*, WALL ST. J., Dec. 16, 1994, at A2; Leslie Wayne, *California County Facing a Huge Loss in Sour Investments*, N.Y. TIMES, Dec. 2, 1994, at A1. Nevertheless, municipal bond issuers still find derivatives useful. Thomas D. Lauricella & Candace Cumberbatch, *Big Municipal Bond*

wants to have its cake and eat it too: it wants the benefits from its good investments, but not the losses from its unlucky ones.⁶⁴

Mutual funds have shown that they too can lack sophistication. Some funds have suffered huge losses from derivatives trading.⁶⁵ A Piper Jaffray mutual fund alone lost some \$700 million due to these instruments, and Paine Webber was forced to put millions of dollars into its funds to offset derivatives losses.⁶⁶ Money market funds that were previously thought to be immune to impairment of capital also suffered losses from derivatives. To avoid that issue, some, but not all, of the funds' managers made good on losses suffered from derivatives.⁶⁷ As a result of these sizable losses, the category "derivatives" has taken on a negative connotation in some circles.⁶⁸

The Orange County debacle has generated much publicity, but Orange County is not the only institution to suffer significant losses from derivatives. Metallgesellschaft A.G., to cite a dramatic example, lost \$1.37 billion from oil-related derivative transactions undertaken by its United States subsidiary.⁶⁹ The parent company closed these positions in a near panic in order to avoid even larger losses. Ironically, it is now claimed that the transactions were erroneously closed because the company

Issuers Turn to Derivatives in an Effort to Bring Down Borrowing Costs, WALL ST. J., Nov. 9, 1994, at C21.

64. According to a newspaper report, Merrill Lynch officials had debated internally about whether to restrict Orange County's trading because of its high risk profile. They were concerned, however, that Merrill Lynch might be viewed as an adviser to the County and hence face liability if they tried to direct or guide the County's trading. See Laura Jereski, *In-House Battle: Merrill Lynch Officials Fought Over Curbing Orange County Fund*, WALL ST. J., Apr. 5, 1995, at A1.

65. See, e.g., Sara Calian, *BankAmerica's Cost to Rescue 2 Funds Soars*, WALL ST. J., July 1, 1994, at A2; *Kitchen-Sink Bonds: Paine Webber's \$180 Million Missetp*, N.Y. TIMES, July 26, 1994, at C1.

66. G. Bruce Knecht, *Piper Manager's Losses May Total \$700 Million*, WALL ST. J., Aug. 25, 1994, at C1; *Running out of Steam*, ECONOMIST, Dec. 24, 1994, at 93.

67. See, e.g., Sara Calian & Georgette Jasen, *Managers Prop Up Money Market Funds With Quiet Bailouts in Face of Losses*, WALL ST. J., June 10, 1994, at C1; Georgette Jasen & Jeffrey Taylor, *Derivatives Force First Closure of Money Fund*, WALL ST. J., Sept. 28, 1994, at C1; Leslie Wayne, *Investors Face First Money Market Fund Loss*, N.Y. TIMES, Sept. 28, 1994, at C1; see also John Greenwald, *The Devil's in the Derivatives*, TIME, Oct. 10, 1994, at 54 (money market fund shuts down as the result of losses from derivatives).

68. See generally Sarah Calian, *To Lure Investors Funds Launch Attack on 'D' Word*, WALL ST. J., Sept. 23, 1994, at C1. But see Saul Hansell, *Derivatives as the Fall Guy: Excuses*, N.Y. TIMES, Oct. 2, 1994, § 3, at 1.

69. Jeffrey Taylor & Allanna Sullivan, *German Firm Finds Hedges Can Be Thorny*, WALL ST. J., Jan. 10, 1994, at C1. The firm's share price dropped to thirty percent of its value before the loss. *Business and Finance*, ECONOMIST, Oct. 1, 1994, at 7. See generally Frances A. McMorris, *Metallgesellschaft Is Said to Be Target of Extortion Plot by Former Employee*, WALL ST. J., Nov. 22, 1994, at B10.

did not understand how they worked and that the losses could have been avoided if the contracts had been left to accomplish their purposes.⁷⁰

Other institutions that have experienced notable losses include the Kashima Oil company in Japan, which lost some \$1.5 billion in currency transactions; Japan Airlines, which lost some \$450 million from currency "hedged";⁷¹ Procter & Gamble, which lost over \$150 million from derivatives; and Kidder Peabody, which lost over \$350 million from what appeared to be fraudulent derivative transactions by one of its own traders.⁷² Hedge funds also have suffered disastrous losses from derivatives,⁷³ as have pension funds, college funds, and municipal authorities.⁷⁴ More recently, Barings PLC, a large, old, British banking institution, lost over \$1 billion and was forced into receivership due to poorly supervised trading in derivatives by a twenty-seven year old trader

70. *A Risky Old World*, ECONOMIST, Oct. 1, 1994, at 18; *Gunning for Metall*, ECONOMIST, Oct. 1, 1994, at 96; *Metallgesellschaft: A Waste of Resources?*, ECONOMIST, Sept. 24, 1994, at 85; *Metallgesellschaft, Answering Back*, ECONOMIST, Oct. 15, 1994, at 104; Sylvia Nasar, *The Oil-Futures Bloodbath: Is the Bank the Culprit?*, N.Y. TIMES, Oct. 16, 1994, at F5.

71. *Business and Finance*, ECONOMIST, Oct. 8, 1994, at 5. Chinese traders also lost heavily in currency transactions. See, e.g., Joseph Kahn, *Currency Futures Take Hefty Toll on Chinese Traders*, WALL ST. J., Dec. 29, 1994, at A6.

72. See Markham, "Confederate Bonds," *supra* note 32, at 132-33; Michael Siconolfi, *Bond Epic, How Kidder, a Tiger in April, Found Itself the Prey by December*, WALL ST. J., Dec. 29, 1994, at A1. For other examples of institutional losses from investments in derivative instruments, see Susan Antilla, *Salomon's Hong Kong Hangover*, N.Y. TIMES, Sept. 18, 1994, at F13 (Hong Kong investors suffer large losses in derivatives); Stuart Elliott, *\$100 Million Loss Is Seen by Salomon*, N.Y. TIMES, Oct. 7, 1994, at C1; Greenwald, *supra* note 67 (Glaxo Holdings loses \$115 million from derivatives); Steven Lipin, *Risk Management Has Become Crucial in a Year When Strategies Proved Wrong*, WALL ST. J., Sept. 29, 1994, at C1 (J.P. Morgan loses more than \$200 million in mortgage backed securities); Sara Webb, *Lehman Sues Chinese Firms Over Big Loans*, WALL ST. J., Nov. 16, 1994, at C1 (Lehman sues over defaults on foreign exchange and swaps totaling over \$100 million).

73. See Laura Jereski, *The Wrong Stuff*, WALL ST. J., Sept. 26, 1994, at A1; Steven Lipin et al., *Portfolio Poker: Just What Firms Do With 'Derivatives' Is Suddenly a Hot Issue*, WALL ST. J., Apr. 14, 1994, at A1 (Granite Hedge Fund loses \$600 million from derivative transactions). See generally Conner Middelmann, *Hedge Funds: Down but not Out*, FIN. TIMES, Nov. 16, 1994, at IX.

74. See Markham, "Confederate Bonds," *supra* note 32, at 132-33. See also Greenwald, *supra* note 67 (Shoshone Indian Tribe loses \$1.5 million from derivatives; Maple Grove, Minnesota loses \$1.4 million); G. Bruce Knecht, *I Owe U.*, WALL ST. J., Sept. 23, 1994, at A1 (small Texas college loses more than \$10 million from derivatives trading); G. Bruce Knecht, *The Aftermath: Hit by Derivatives, Florida County Tries to Decide What to Do*, WALL ST. J., Apr. 5, 1995, at A1 (Florida County loses some \$25 million on derivatives); Knecht, *supra* note 2 (Charles County, Maryland loses \$5 to \$7 million trading derivatives and City College of Chicago loses some \$45 million). Several banking institutions have also apparently suffered serious losses. See Saul Hansell, *For Banks, Time of Reckoning*, N.Y. TIMES, Dec. 22, 1994, at C1.

in one of its foreign offices.⁷⁵ Chemical Bank lost some \$70 million from unauthorized currency transactions by one of its employees,⁷⁶ and one of the largest credit unions in America was seized by federal regulators after it suffered large losses in derivatives.⁷⁷

2. *Playing Victim: The Institutions Sue*

Some of the institutions suffering losses from derivatives are now claiming that they were victimized by the banks or other derivative dealers who sold them the instruments.⁷⁸ Many lawyers seem to seek victim status for their clients, particularly where the client's crimes or follies are so great as to allow no other defense. Victimization claims by institutions that assert that they are too unsophisticated to assess investment risks raise that effort to new levels.⁷⁹ Nevertheless, the academic community apparently gives credence to these claims.⁸⁰

This concern is not an entirely novel one. Institutions have tried in the past to shift onto others the blame, and the loss, that resulted from their trading activities. Those earlier efforts, however, did not involve

75. Nicholas Bray & Lawrence Ingrassia, *Losses at Barings Grow to \$1.24 Billion: Authorities Begin Sale of 'Good' Assets*, WALL ST. J., Feb. 28, 1995, at A3; *A Royal Mess: Britain's Barings PLC Bets on Derivatives—And the Cost Is Dear*, WALL ST. J., Feb. 27, 1995, at A1.

76. Timothy L. O'Brien, *Chemical Bank Incurs Big Loss in Peso Trading*, WALL ST. J., Jan. 4, 1995, at A3.

77. G. Bruce Knecht, *Regulators Seize Credit Union Organization*, WALL ST. J., Feb. 2, 1995, at A3; G. Bruce Knecht, *Derivatives Holdings of Credit Unions Scrutinized*, WALL ST. J., Feb. 10, 1995, at C1 (derivative trading causes the biggest credit union failure in history); G. Bruce Knecht, *Bad Bet: The Derivatives Mess Touches Employees at the White House*, WALL ST. J., Feb. 1, 1995, at A1; see also Randall Smith & John Connor, *Matter of Security: Risky Derivatives Are Huge Source of Funds for Federal Agencies*, WALL ST. J., Jan. 20, 1995, at A1 (derivatives issued by government financing unit cause large losses to Army welfare and recreation fund).

78. Knecht, *supra* note 2.

79. As one commentator has stated, "It is hard to escape the conclusion that big companies like this should not be playing games they don't understand." Floyd Norris, *Market Watch, Procter's Tale: Gambling in Ignorance*, N.Y. TIMES, Oct. 30, 1994, § 3, at 1. See also Harold Ticktin, *Derivatives: The Parker Bros. Test*, N.Y. TIMES, Oct. 9, 1994, at F9 (arguing investment officers at institutions trading in derivatives should be tested to assure they know how to play Monopoly).

80. Susan Antilla, *Wall St. Ethics Meeting Isn't Open to the Public*, N.Y. TIMES, Feb. 9, 1995, at C2 (Columbia University law professor argues that even sophisticated customers may need to be told not to engage in particular transactions); Saul Hansell, *Challenged Bank Defends its Derivatives Actions*, N.Y. TIMES, Oct. 13, 1994, at C5 (University of Texas law professor states that before derivative instruments, a corporation was "automatically assumed to be sophisticated," but now there is "not such a binary world" and a "spectrum of sophistication").

claims to widow and orphan status. Rather, they generally asserted that the institution's own employees were acting in an unauthorized manner in conducting the trading that caused the loss. The institutions asserted that the broker accepting the orders, rather than the institution itself, should bear the loss caused by the trading of the institution's unauthorized employee.

In the futures industry, for example, there have been several major suits charging that broker-dealers did not protect their institutional customers from the speculative activities of the institutions' own employees.⁸¹ Strangely, the CFTC and some courts have seemed quite willing to accept such claims. In *Baird v. Hales*,⁸² for example, the CFTC stated that a broker could be liable for the speculations of a third party controlling a customer's hedge account. Similarly, in *Evanston Bank v. ContiCommodity Services, Inc.*,⁸³ a district court stated, in denying summary judgment, that a broker could be liable for speculative transactions by a savings and loan. Federal regulations prohibited savings and loans from engaging in such speculative transactions. In essence, the court held that the broker would be liable if it failed to monitor the employee of its institutional client.⁸⁴

81. This is not a novel approach. The savings and loan debacle resulted in an aggressive quest for a "responsible" culprit. In search of a deep pocket, the government and private investors have sued the lawyers and accountants for the failed banks and thrifts. These suits generally charge, in one form or another, that accountants and lawyers failed to prevent the officers of these institutions from committing fraud. These claims seem to be premised on an underlying belief that institutions must be protected from the follies of their officers by professionals that service the organization and that an equal duty runs from these professionals to the institution's customers. See generally *FDIC v. O'Melveny & Myers*, 969 F. 2d 744 (9th Cir. 1992), *rev'd*, 114 S. Ct. 2048 (1994); *In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424 (D. Ariz. 1992); PRACTICING LAW INST., LITIGATING FOR AND AGAINST THE FDIC AND THE RTC 1993; Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 559-74 (1994) (discussing efforts by the SEC and banking agencies to hold lawyers responsible for the actions of their clients); Harris Weinstein, *Attorney Liability in the Savings and Loan Crisis*, 1993 U. ILL. L. REV. 53. Cf. *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S.Ct. 1439 (1994) (holding that private plaintiff may not maintain aiding and abetting liability suit under Section 10(b) of the Securities Exchange Act of 1934).

82. [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,856 (C.F.T.C. 1985). Nevertheless, the CFTC applied estoppel to bar recovery. *Id.*

83. 623 F. Supp. 1014 (N.D. Ill. 1985).

84. See also *Katara v. D.E. Jones Commodities, Inc.*, 652 F. Supp. 907, 913 (S.D.N.Y. 1986) (sustaining fraud claim based on allegation that broker had told client that stock index futures were "safe"), *rev'd*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,007 (2d Cir. 1987); *Frye v. Northpoint Agricultural Resources, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,076 (C.F.T.C. 1992); *In re Interstate Sec. Corp.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,295, at 38 (C.F.T.C. 1992) (broker liable where employee of a financial institution traded on the

Perhaps the most extreme case of all is *Drexel Burnham Lambert, Inc. v. CFTC*.⁸⁵ There, a corporation claimed that it had been defrauded by its broker through the entry of unauthorized transactions into its account. The trades had been entered by an employee of the company who was a convicted felon and a compulsive gambler. The corporation claimed that this individual was not authorized to enter the trades at issue and that liability should, therefore, rest with the broker. The CFTC and the D.C. Circuit Court of Appeals accepted this argument, holding Drexel liable because it failed to determine whether the employee was authorized to enter into the trades in question. This suggests that a corporation cannot monitor its own officers and must, therefore, depend on the restrictive protection normally imposed on broker-dealers that deal with the widows and orphans of the world.⁸⁶

One derivatives case that arose from the recent spate of losses deserves particular attention even though it was subsequently settled. In *Gibson Greetings, Inc. v. Bankers Trust Co.*,⁸⁷ Gibson Greetings, an international firm that manufactures and sells greeting cards, alleged that it had been misled and abused by its prime bank, Bankers Trust, through the offer and sale of a "LIBOR-squared" transaction. The transaction required that "Gibson would receive a fixed interest rate and pay a floating interest rate based on a calculation requiring the squaring of the London Interbank Offered Rate (LIBOR) for six month time deposits of U.S. dollars."⁸⁸ Gibson had previously engaged in swaps, but premised

institution's account in an unauthorized manner); *Plywood Wholesalers, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, C.F.T.C. Slip Op. (July 26, 1982) (broker liable for hedging recommendations to a commercial hedger); *State v. Morgan Stanley*, 416 S.E.2d 55 (W. Va. 1992) (broker liable for state agency's trading where agency alleged to have exceeded its authority); Michael Siconolfi, *Brokerage Firms Pay Big Damages in 'Dramshop' Cases*, WALL ST. J., May 17, 1995, at C1 (large damage award entered against firm for not preventing a wealthy investor from committing "financial suicide").

85. 850 F.2d 742 (D.C. Cir. 1988). The author was counsel to Drexel Burnham Lambert on the appeal in this case.

86. *But see* Thomson McKinnon Secs., Inc. v. Clark, 901 F.2d 1568 (11th Cir. 1990), cert. denied, 498 U.S. 1027 (1991). In this security options case, the Eleventh Circuit held that an experienced customer could not escape liability for nonpayment of margin by claiming that a broker violated exchange rules by overextending credit to the customer. The court held that when an experienced customer expressly requests his broker to ignore a contractual provision, in this case the margin account provision for payment of margins, the customer will be deemed to have waived that requirement.

87. *Gibson Greetings, Inc. v. Bankers Trust Co.*, Civ. No. 1-94-620 (S.D. Ohio Sept. 12, 1994) [hereinafter *Gibson Greetings*]. See generally *Bankers Mistrust*, ECONOMIST, Nov. 19, 1994, at 87; *Exiled on Wall Street: Bankers Trust: A Bum Rap for Derivatives?*, NEWSWEEK, Nov. 14, 1994, at 49.

88. *Gibson Greetings*, supra note 87. Gibson Greetings also entered into a Treasury-linked swap and a "knock-out" call option. In the Matter of BT Securities Corp., Securities

its victim status on the assertion that it otherwise had no expertise with derivatives, that it advised Bankers Trust that it did not want to speculate, that it was relying on Bankers Trust for advice, and that "Gibson justifiably believed that it had entered into a special relationship of trust and confidence with Bankers Trust."⁸⁹

Gibson Greetings aroused a great deal of controversy and incited regulators to bring disciplinary actions against Bankers Trust.⁹⁰ The case was settled after regulators discovered that Bankers Trust had misled Gibson Greetings on the valuation of its losses and market position.⁹¹

Act Release No. 7124 (Dec. 22, 1994).

89. Complaint at 6, *Gibson Greetings*, *supra* note 87. Procter & Gamble has filed a similar suit against Bankers Trust. See Steven Lipin, *Bankers Trust Says P&G Deal Wasn't Unique*, WALL ST. J., Nov. 22, 1994, at C1; Floyd Norris, *Procter's Tale: Gambling in Ignorance*, N.Y. TIMES, Oct. 30, 1994, § 3, at 1. Procter & Gamble lost some \$157 million as the result of "a swap in which its payments were tied to both the yield on five-year U.S. Treasury notes and the price of thirty-year U.S. Treasury bonds." Jeffrey Taylor, *Bankers Trust Faces Inquiry on Derivative Sales*, WALL ST. J., Nov. 1, 1994, at C1. Among other things, Procter & Gamble's complaint alleged that this swap had huge concealed risks and that Bankers Trust had repeatedly represented that it had "superior expertise" with these swaps. Complaint at 5, 7, *Procter & Gamble Co. v. Bankers Trust*, Civ. No. C-1-94-735 (S.D. Ohio Oct. 27, 1994). See generally *Bankers Trust's Dirty Linen*, ECONOMIST, Feb. 11, 1995, at 68; G. Bruce Knecht, *P&G Amends Its Bankers Trust Suit to Get More Money*, N.Y. TIMES, Feb. 7, 1995, at D9; *P&G Amends Lawsuit Naming Bankers Trust*, WALL ST. J., Feb. 7, 1995, at A3. Cf. Rita Koselka, *Safe When Used Properly*, FORBES, Aug. 15, 1994, at 47 ("We can understand P&G's embarrassment, but we can't buy the alibi that this \$30 billion globe-spanning outfit was a naive victim.").

90. In the Matter of BT Securities Corp., Securities Act Release No. 7124 (Dec. 22, 1994); In the Matter of BT Securities Corp., CFTC Doc. No. 95-3 (Dec. 22, 1994).

91. Bankers Trust initially reassigned some of its staff after an internal probe of the derivative claims made against it. See Samuel Hansell, *Executives Suspended by Bank*, N.Y. TIMES, Nov. 14, 1994, at D1; Steven Lipin, *Bankers Trust Reassigns Executives in Midst of Internal Sales-Practice Probe*, WALL ST. J., Nov. 14, 1994, at A3. Thereafter, it settled the case with Gibson Greetings, reducing Gibson Greetings' remaining liability from some \$20 million to \$6.2 million. John Connor and G. Bruce Knecht, *Bankers Trust Facing Action on Derivatives*, WALL ST. J., Dec. 5, 1994, at A3; Steven Lipin, *Gibson Greetings Reaches Accord in Suit Against Bankers Trust over Derivatives*, WALL ST. J., Nov. 25, 1994, at A3. Bankers Trust also later settled charges brought by the CFTC and the SEC and entered into a settlement with banking authorities. *Bankers Trust Settles Charges on Derivatives*, WALL ST. J., Dec. 23, 1994, at C1; Saul Hansell, *Bankers Trust and U.S. Set Pact on Disclosure of Derivatives' Risk*, N.Y. TIMES, Dec. 6, 1994, at A1; Jerry Knight, *Derivatives Dealer Fined \$10 Million: Agency Cites 'Fraud' by Bankers Trust Unit*, WASH. POST, Dec. 23, 1994, at A1; Carol J. Loomis, *Untangling the Derivatives Mess*, FORTUNE, Mar. 20, 1995, at 50, 54, 58-60; Richard Waters, *U.S. Bank Agrees to Derivatives Controls*, FIN. TIMES, Dec. 6, 1994, at 1.

The suit by Procter & Gamble continues, and other claims are being filed against Bankers Trust. Brett D. Fromson, *Bankers Trust, Gibson Settle Derivatives Suit*, WASH. POST, Nov. 24, 1994, at D1; Steven Lipin, *Bankers Trust Woes Spread to Money Unit*, WALL ST. J., Dec. 8, 1994, at A3. Bankers Trust also faces other problems from its derivative activities. Saul Hansell, *Big Bank's Derivative Problems, Larger Scope Cited by*

However, the larger issue of whether Bankers Trust owed a duty to protect Gibson Greetings from inappropriate investments was left unresolved. One regulator asserted that there was no effort being made to establish a requirement that derivative dealers ensure that their transactions are suitable for their institutional customers.⁹² The Federal Reserve Board did, however, require that Bankers Trust provide its customers with sufficient information to allow the customers to understand the terms and risks of the derivative instruments being sold.⁹³

The assertions and the publicity that resulted from this episode raise interesting concerns about the role of the Gibson Greetings officials who authorized these transactions. The unusual nature of these investment positions must have raised some questions as to the manner of their operation and the risks they posed. A responsible financial officer should have examined these unusual transactions to assess the risks they posed, as well as their utility.

Another relevant issue is the failure of Gibson Greetings' board of directors in its oversight responsibilities.⁹⁴ The board should have assured that management was monitoring the trading of such exotic and complex instruments. If the claims made in Gibson Greetings' complaint are true, there is a question of how such an institution can also claim that it is a sophisticated investor entitled to the benefits of an exempted class under the federal securities laws or the Commodity Exchange Act, or that it should be given other exemptive relief that is based on its presumed sophisticated status as an institutional investor.

Instead of focusing on the derivatives dealers,⁹⁵ regulators could shift their attention to those institutions claiming "victim" status. If institutions

Bankers Trust, N.Y. TIMES, Jan. 20, 1995, at D1; G. Bruce Knecht, *Bankers Trust 4th-Period Net Fell 64% as Many Derivatives Pacts May Default*, WALL ST. J., Jan. 20, 1995, at A3; *Till Debts Do Us Part*, ECONOMIST, Jan. 28, 1995, at 69.

92. Tim W. Ferguson, *Commodities Boss Forswears Future in Swaps*, WALL ST. J., Jan. 3, 1995, at 9.

93. Federal Reserve Bd. Press Release, Dec. 5, 1994, *Re: Written Agreement by Bankers Trust New York Corp. et al.*, Doc. No. 94-082-WA/RB-HC. The amount of disclosure made by derivative dealers to their customers continues to be a matter of concern. Saul Hansell, *Derivatives Draw More Scrutiny*, N.Y. TIMES, Jan. 3, 1995, at C39.

94. Bankers Trust asserted that Gibson's management was informed of the risks of these transactions. Saul Hansell, *Challenged Bank Defends Its Derivatives Actions*, N.Y. TIMES, Oct. 13, 1994, at D4; Steven Lipin, *Bankers Trust Says Gibson Greetings Was Fully Aware of Derivatives' Risk*, WALL ST. J., Oct. 13, 1994, at A4.

95. *Signed, Sealed*, ECONOMIST, Dec. 10, 1994, at 81; Jeff Bailey, *SEC Charges Broker With Civil Fraud in Sale of Derivatives to Municipalities*, WALL ST. J., Dec. 28, 1994, at A4. The SEC brought another enforcement action against a dealer that was selling "toxic waste" derivatives (so-named because of the risks they pose) through fraudulent sales practices. *Id.*

were threatened with losing their privileges to invest in unregulated markets, they might be less inclined to bring lawsuits against their brokers whenever an investment went sour.⁹⁶

B. *The Shortcomings of Current Legal Remedies*

An institution suffering losses from a complex financial transaction may claim, as did Gibson Greetings, that its institutional sophistication is limited in scope and that it is no more sophisticated than a widow or orphan in the area of complex financial instruments. The argument has some appeal.⁹⁷ A manufacturer of greeting cards or other consumer or industrial products may not have a treasurer's office or chief financial officer that follows all of the complexities of the new instruments that are constantly being developed on Wall Street. Yet it seems reasonable to ask the institution's financial officers to analyze a project for risk and reward before committing corporate funds.

The consideration of claims made by the "unsophisticated" institution brings three legal concepts into play: suitability, reliance, and fiduciary duties. Each must be analyzed to reach a viable solution for the institutional "widow" or "orphan."

1. *Suitability Requirements*

The suitability concept was developed under the federal securities laws and until recently has generally been limited to the securities industry.⁹⁸ Simply stated, this concept precludes a securities broker from recommending a securities transaction that is not suitable for the customer receiving the recommendation because of that customer's particular

96. The SEC does plan to expand disclosure requirements with respect to firms that use derivatives. Lee Berton, *SEC Plans to Expand Disclosure Rules Covering Derivatives Used to Hedge Risk*, WALL ST. J., Jan. 17, 1995, at A2. The agencies will also predictably seek to push over-the-counter trading onto the exchanges, where more control and greater protection are available. See Alfred Steinherr, *Taming the Wild Beast of Derivatives*, FIN. TIMES, Dec. 16, 1994, at 18 (advocating movement away from less regulated OTC markets toward organized exchanges); cf. David Dishneau, *CBOT Leader Gets a Scolding*, RALEIGH NEWS & OBSERVER, Nov. 19, 1994, at D1 (CFTC rejects exchange effort to compete with over-the-counter derivatives by exempting pension plans and other institutions from CFTC regulations).

97. See generally Saul Hansell, *Challenged Bank Defends Its Derivatives Actions*, N.Y. TIMES, Oct. 13, 1994, at D4.

98. At least one court has applied this concept to insurance products. *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961), cert. denied, 370 U.S. 915 (1962) (misrepresentations made concerning the suitability of an insurance program).

investment needs and objectives. This is a subjective test that requires an analysis of each customer's financial circumstances and goals.⁹⁹

The genesis of this concept is the New York Stock Exchange "know-your-customer" rule.¹⁰⁰ The rule requires brokers to obtain information about the financial circumstances of customers before recommending a trade.¹⁰¹ The rule's original purpose was to protect brokers from their customers. Brokers were required to gather this information to assure that their customers had the ability to meet their financial obligations in securities operations.

The suitability concept evolved into a protection for the customer from broker recommendations unsuited to the customer's needs.¹⁰² This is a very paternalistic approach to customer protection. Arguably, it is also a very sound approach where an unsophisticated customer is relying on the financial expertise of a broker.¹⁰³ The requirement does not seem to make much sense where a sophisticated customer is involved. Such a customer can presumably look out for itself.

The CFTC has rejected the suitability approach taken by the securities industry, even where unsophisticated investors are involved.¹⁰⁴ The CFTC believes that its disclosure requirements offer sufficient protection to customers who must be warned that they themselves should consider whether they are suitable for futures trading.¹⁰⁵

In the futures industry, customers trading futures contracts must be given a one-page statement setting forth some of the more obvious risks

99. NICHOLAS WOLFSON ET AL., REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.08 (1977).

100. Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2,405 (1982).

101. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), *amended*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96, 525 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978), *aff'd on cross-appeal, rev'd and remanded on principal appeal*, 637 F.2d 77 (2d Cir. 1980).

102. *See, e.g.*, NASD Rules of Fair Practice Art. III, § 2.

103. *See, e.g.*, *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 601 (2d Cir. 1978) (broker failed to inform customer of the unsuitability of her investments); *Yancoski v. E.F. Hutton & Co.*, 581 F. Supp. 88, 92 (E.D. Pa. 1983) (broker told customer that only safe investments were being made). *See generally* JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD MANIPULATION AND OTHER CLAIMS § 10.02 (1987).

104. The CFTC's determination to reject a suitability standard has a long and convoluted history. *See* MARKHAM, *supra* note 103, §§ 10.03-.07.

105. *Phacelli v. ContiCommodity Services, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,345 (C.F.T.C. 1986); *Martin v. Shearson Lehman/American Express, Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,354 (C.F.T.C. 1986). *Cf. Ho v. Dohmen-Ramirez*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,391 (C.F.T.C. 1986), *aff'd*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,101 (9th Cir. 1988) (broker liable for trading customer's account in utter disregard of the manner expected by the customer).

involved in trading these contracts.¹⁰⁶ The CFTC draws no distinction between institutional investors and individual customers in rejecting the suitability approach.¹⁰⁷ Even though these markets are extremely complicated and highly risky, individual and institutional investors must themselves assess the risks of trading, rather than rely on the assessments of their brokers.¹⁰⁸

The courts also seem reluctant to expand the suitability concept even to allow damage claims on the part of unsophisticated investors who receive unsuitable recommendations.¹⁰⁹ Yet at least one banking regulator has sought to impose a suitability standard on banks marketing over-the-counter derivative instruments.¹¹⁰ That, however, may have been a panicked response to the explosive growth in sales of those instruments and the large losses that some investors experienced with them.¹¹¹

106. 17 C.F.R. § 1.55 (1994). *See generally* MARKHAM, *supra* note 103, § 10.07 (1987).

107. *Phacelli v. ContiCommodity Services, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,345 (C.F.T.C. 1986) (no liability for suitability unless customer is exceptionally stupid or gullible and broker knows of that disability and seeks to take advantage of it).

108. The courts have generally accepted the CFTC's approach. *See, e.g.*, *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,205 (5th Cir. 1992); *Dyer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 928 F.2d 238 (7th Cir. 1991); *Schofield v. First Commodity Corp. of Boston*, 793 F.2d 28 (1st Cir. 1986). Administrative law judges at the CFTC, however, do seem inclined to find misrepresentations when unsophisticated traders are induced to participate in the futures markets. *See* MARKHAM, *supra* note 103, § 10.07 (1987).

109. *See, e.g.*, *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1419 (11th Cir. 1983). *Cf. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 142-43 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969) (private right of action allowed for breach of "know your customer" rule where the conduct was tantamount to fraud). *See generally* Note, *The Suitability Rule: Should a Private Right of Action Exist?*, 55 ST. JOHN'S L. REV. 493 (1981).

110. Kenneth H. Bacon, *U.S. Guidelines on 'Derivatives' Obliging Banks to Mull Customer Needs*, WALL ST. J., Oct. 28, 1993, at A24; Office of the Comptroller of the Currency, Questions and Answers for Banking Circular 277, OCC Bulletin 94-31 (May 10, 1994).

111. Unfortunately, additional losses in derivatives have led bank regulators to further embrace suitability standards. Keith Bradsher, *Three Federal Agencies Act to Curb Certain Derivatives*, N.Y. TIMES, Nov. 19, 1994, §1, at 41 (suitability requirements for structured notes); Saul Hansell, *Mellon Takes \$130 Million Loss on Investments*, N.Y. TIMES, Nov. 29, 1994, at D4 (bank reimburses customers \$130 million for losses on structured notes); Matt Murray & Gary Putka, *Mellon Bank Plans a Charge of \$130 Million*, WALL ST. J., Nov. 29, 1994, at A2. *But see Regulating Derivatives*, FIN. TIMES, Dec. 30, 1994, at 13 ("it is not the task of central bank regulators to protect large industrial companies from their bankers").

NASD has also sought public comment on an interpretation that would apply its suitability rule to institutional customers in some instances. The interpretation is somewhat ambiguous. Apparently, it would apply the suitability requirement where a broker-dealer

Imposing a suitability requirement on firms dealing with institutional investors seems unnecessary.¹¹² The institution can look out for its own interests. Further, in conducting transactions with a derivatives dealer, the institution is dealing at arm's length with an equal. Consider how inappropriate it would be to claim that a manufacturer must protect its institutional suppliers from improvident bargains. How does the institutional investor's claim differ, unless there has been fraud or deception?

2. *Reliance Claims*

In *Zobrist v. Coal-X, Inc.*,¹¹³ the Tenth Circuit held that information contained in a private placement memorandum would be imputed to a sophisticated businessman even though he had failed to read the document. The court held that the businessman's reliance on oral misrepresentations that conflicted with the memorandum was not justified.¹¹⁴ This seemed to signal that the sophistication of customers could negate their claims of reliance on oral statements of their brokers or advisers. Thus, in *Kennedy v. Josephthal*,¹¹⁵ the First Circuit took note of, among other things, the sophistication of plaintiffs in finding no justifiable reliance on oral misrepresentations.¹¹⁶

The courts have refused to go so far as to impose an affirmative duty of inquiry on the part of investors, and unsophisticated investors may be given more protection than the businessman in *Zobrist*.¹¹⁷ In *Wegerer v. First Commodity Corp.*,¹¹⁸ the Tenth Circuit rejected a claim that investors were given adequate warnings of risk from statements in risk

has reason to believe that an institutional customer is relying on a broker-dealer's recommendation and is not making an independent analysis of the broker-dealer's advice. National Ass'n of Securities Dealers Notice 94-62 (Aug. 1994).

112. See *Unsuitable: It Is Wrong to Protect Companies and Professional Investors from Their Own Actions*, *ECONOMIST*, Dec. 3, 1994, at 18.

113. 708 F.2d 1511 (10th Cir. 1983).

114. See also *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988); *Platsis v. E. F. Hutton & Co.*, 642 F. Supp. 1277 (W.D. Mich. 1986).

115. 814 F.2d 798, 804-5 (1st Cir. 1987).

116. See also *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1418-19 (11th Cir. 1983) (Customer could not recover damages because he knew or could have ascertained the risks of his investment with the exercise of reasonable diligence. The customer was an experienced businessman).

117. For discussion of assertions that investors should act with due diligence before making claims under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, see THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 13.12 (2d ed. 1990); Note, *The Due Diligence Requirement for Plaintiffs under Rule 10b-5*, 1975 *DUKE L. J.* 753.

118. 744 F.2d 719 (10th Cir. 1984).

disclosure documents. The court in that case found that the customers were not sophisticated investors, were lied to repeatedly, and were badgered into investing by numerous telephone calls. The investors were also told not to read the risk disclosure materials because they were purportedly given to customers merely to comply with legal requirements. The court distinguished *Zobrist*¹¹⁹ because the customers were not sophisticated.¹²⁰

In *Indosuez Carr Futures, Inc. v. CFTC*,¹²¹ the Seventh Circuit considered the assertion that fraud claims under the Commodity Exchange Act contain a "reasonable reliance" requirement comparable to that found in common law fraud claims. Such a standard would impose a duty on the customer to investigate broker statements. The court concluded that fraud claims under the Commodity Exchange Act and the federal securities laws do not contain such a requirement. It apparently believed, correctly, that customers have a right to rely on the representations of their brokers. The court also noted, however, that reliance may bar recovery where customers close their eyes to a known risk, where written materials given to the customers contradict oral misrepresentations, or where the customer's knowledge is equal to that of the broker.¹²²

The CFTC seems to take a harsher view of reliance claims, and it employs the related concept of causation to dismiss fraud claims for which it has no sympathy. For example, in *Steen v. Monex Int'l, Ltd.*, the CFTC held that a customer seeking damages for violations of the Commodity Exchange Act must show that the alleged violative conduct proximately caused the customer's losses.¹²³ Here, the customer was a sophisticated and savvy trader, and she knew that the market could not be predicted,

119. 744 F.2d at 723.

120. Nevertheless, other cases have suggested that an investor may not shift blame to her broker or avoid an obligation where the investor had the opportunity but failed to inform herself about a matter affecting the investment. *Cf. Ingbar v. Drexel Burnham Lambert, Inc.*, 683 F.2d 603, 607 (1st Cir. 1982) (customer bound by terms of arbitration agreement in commodity futures contract even though he had not read it); *McNally v. Gildersleeve*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,006 (8th Cir. 1994) (justifiable reliance required for fraud claim).

121. [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,125 (7th Cir. 1994).

122. *But see Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530 (7th Cir. 1985) (lackadaisical investigation of loan by pension fund trustees did not relieve defendant of liability for inducing loan); *cf. Indemnified Capital Investments, S.A. v. R.J. O'Brien & Assocs.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,916 (7th Cir. 1993) (common law fraud claim rejected where customers could have obtained trading performance evaluations that would have belied defendants' claims of success).

123. [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,245, at 38,723-24 (C.F.T.C. 1992).

notwithstanding the claims made by her broker. In a concurring opinion, the CFTC's former chairman would have imposed a requirement that customers use due diligence in protecting themselves against fraudulent conduct.¹²⁴

Interrelated with the reliance issue is the nature of the customer's investing experience. Does the customer's sophistication and investment experience translate from the securities or other fields to commodity futures trading? In *Cohen v. Manganiello*,¹²⁵ the investor was an engineer who held advanced degrees, had previously purchased commodity pool units, and had some securities experience. The CFTC held that these factors were relevant in assessing reliance but were insufficient to overcome the specific misrepresentations at issue.¹²⁶ The CFTC distinguished a district court decision in *Peterson v. Lincolnwood*, where lack of reliance was found on the part of the plaintiff, who was a stockbroker, a member of the National Association of Securities Dealers (NASD), and a person with eighteen years of experience in the stock market who admitted that he was familiar with the practices of the commodities market.¹²⁷

124. *Id.* at 38,726. In *Rutten v. Meyer*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,376 (C.F.T.C. 1992), the CFTC refused to defer to an administrative law judge's assessment of the complainant's proof of reliance and causation. The complainant asserted that he was unfamiliar with the complexity of futures trading, but the record disclosed that he had previously traded and had been given a risk disclosure document. Further, the customer failed to protest numerous losses in his account that were in excess of the loss limitation claims allegedly made by the broker. *See also Heublein v. International Trading Group, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,591 (C.F.T.C. 1992) (customer should have realized that broker's claims were false after sustaining losses that belied those assertions); *Wolken v. Refco, Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,779 (C.F.T.C. 1987) (no reliance shown where the customer was a sophisticated investor); *Walton v. Heinhold Commodities, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,136 (C.F.T.C. 1985) (complainant without actual knowledge of fraud may still be estopped from recovery where ignorance is result of willful disregard of facts or gross negligence).

125. [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,346 (C.F.T.C. 1986).

126. In *Weinberger v. First Nat'l Monetary Corp.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,845 (C.F.T.C. 1985), *aff'd*, 819 F.2d 1334 (6th Cir. 1987), however, the CFTC rejected claims that a customer's experience in trading securities should have precluded him from relying on the misrepresentations of a broker. The CFTC stated that "sophistication and experience are not the only factors to be considered in resolving reliance issues." *See also Cohen v. Manganiello*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,346 (C.F.T.C. 1986) (sophistication of investor did not negate reliance on specific misrepresentations).

127. [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,576 (S.D.N.Y. 1985); *see also Puckett v. Rufenacht Bromagen & Hertz, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,520 (S.D. Miss. 1989), *aff'd*, 903 F.2d 1014 (5th Cir. 1990) (investor's experience relevant to reliance).

In a later case, *In re JCC, Inc.*, the CFTC stated that an administrative law judge erred in limiting cross-examination on the securities and other investment experience of customers in determining whether they had been defrauded by misrepresentations.¹²⁸ The administrative law judge had allowed examination on the customers' futures related experience but not on their securities experience. The CFTC stated that such a bright line test ignored similarities that exist between futures and securities investments. Nevertheless, in *DeRance, Inc. v. Paine Webber, Inc.*, the Seventh Circuit held that a district court did not abuse its discretion in excluding specific details about a customer's non-futures investments.¹²⁹ The customer was claiming a lack of sophistication. The brokerage firm wanted to show that the customer was a speculator who had lost millions of dollars trading penny stocks, silver mines, deep-sea treasure hunts, and Mexican mutual funds. The court found that these investments were not directly probative of whether fraud had been committed by the defendants.

These cases, for the most part, fail to focus on some fundamental concerns. Congress and regulators have made a determination that institutional investors are a special class. They do not need the broad regulatory safety net that is spread wide for small investors, and institutions should not be required to incur the costs and inefficiencies of that regulatory net. Logically, the tradeoff for such an exemption is that the institution will incur a responsibility to read disclosure documents and investigate investment opportunities to determine the risks of its transactions. Claims of reliance on isolated oral statements of salespersons are not in keeping with the expected role of a sophisticated institution.

3. *Breach of Fiduciary Duty*

The fiduciary duty concept has also been adapted to provide protection for the unsophisticated in financial transactions, particularly where they are dependent on the expertise of their broker or another professional. In brief, this concept requires a person in a position of trust and confidence to use special care in carrying out his or her duties under that relationship.¹³⁰

128. [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,080 (C.F.T.C. 1994).

129. [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,450 (7th Cir. 1989).

130. For a discussion of the development of the fiduciary concept and its application in the financial services industries see Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 NOTRE DAME L. REV. 199 (1992).

The difficulty with fiduciary duties is that the exact standard of care is never spelled out, and the scope of duties will vary according to the particular nature of the relationship. For example, a broker that simply executes an order for a customer will have only a narrow range of fiduciary duties, while a broker with complete discretionary control over a customer's account will be subject to the broadest range of fiduciary responsibilities. Thus, there is a sliding scale of duties that increase as the broker exercises greater control over the customer's trading.¹³¹

The fiduciary duty concept has met heavy criticism in recent years because it seeks to impose non-contractual duties on contractual relationships, though the parties did not bargain for such duties.¹³² Critics argue that contractual negotiations and market discipline are more efficient regulators than the courts or government agencies who seek to invent fiduciary duties to govern the parties' liabilities when a dispute or overreaching occurs.¹³³ Fiduciary duties seem particularly inappropriate where two institutions are dealing with each other in an arms-length relationship.¹³⁴

The critics of fiduciary duties seem to be making some impact on the courts. For example, in *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, the Fifth Circuit certified to the Mississippi Supreme Court questions to determine what, if any, fiduciary duties commodities brokers owe to their customers.¹³⁵ The Mississippi Supreme Court responded that a customer seeking speculative profits was not owed a duty by the broker to prevent the customer from committing financial suicide. The court stated that the fiduciary duties of a broker end with the duty to carry out a customer's instructions.¹³⁶

131. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

132. The Supreme Court has refused to adopt a broad fiduciary standard for liability under the Securities Exchange Act of 1934. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). Nevertheless, fiduciary duties may play a role in determining whether individuals are liable for insider trading when they "misappropriate" corporate information. See generally *Carpenter v. United States*, 484 U.S. 19 (1987).

133. See generally Robert C. Clark, *Insider Trading as an Agency Problem*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 76, (John W. Pratt & Richard J. Zeckhauser eds., 1984); Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 NW. L. REV. 1 (1985).

134. See Markham, *supra* note 130.

135. *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 903 F.2d 1014, 1021 (5th Cir. 1990). The questions certified by the Fifth Circuit are set forth at *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 919 F.2d 992, 994 (5th Cir. 1990).

136. *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 2 Comm. Fut. L. Rep. (CCH) ¶ 25,144 (Miss. 1991).

The Seventh Circuit has also become a center for jurists who seek to curtail the application of fiduciary duties to financial transactions and investments. See, e.g., *Jordan*

In fact, institutional investors should not be treated as widows and orphans who must be protected from derivative instruments by fiduciary duties. Unlike unsophisticated investors who need the protection of fiduciary duties, institutions have the capability to make their own investment analysis. Alternatively, they can retain an independent adviser to assess the recommendations they receive from the purveyors of complex financial instruments.

Sober reflection should result in the rejection of the paternalistic approach of the fiduciary duty concept as applied to institutions. Any firm should be able to assume that an institution has the "independent" capability to assess the risk of its investments if that institution has the status of an accredited investor under the federal securities laws or is an exempt institution under the Commodity Exchange Act. Such an institution should also be able to assess its own investment objectives, needs, and abilities.¹³⁷

C. *Deregulation, Responsibility, and Risk*

The deregulation of institutional trading is a progressive measure designed to enhance market efficiency and to reduce the regulatory costs and burdens imposed on institutions. That relief, however, should carry with it the responsibilities that are the premise for its grant. Institutions can and should make their own risk assessments. Institutions should not be able to claim the benefits of deregulation unless they are also prepared to assume its costs.

Admittedly, an institution may need protection in certain instances. Anti-fraud prohibitions are necessary even for the most sophisticated institution. In some cases, institutions may not have the ability to assess the risks of a particular instrument or trading program. For example, a manufacturing firm that has a predictable cash flow and little need for

v. Duff and Phelps, Inc., 815 F.2d 429 (7th Cir. 1987) (Easterbrook, J.), *cert. dismissed*, 485 U.S. 901 (1988).

137. There is a definite need to clarify the obligations of derivative end users so that they may understand the risks they are incurring. A recent survey indicates that many institutions believe derivative dealers should protect them from risks, or at least share responsibility, and that dealers should ensure that the institution's own employees are authorized to trade. See Suzanne McGee, *Derivatives Risk Should Be Shared, Users Survey Says*, WALL ST. J., Apr. 25, 1995, at C15.

The category of institutions that may be sold derivative instruments continues to expand. Martha Brannigan, *First Union, Undeterred by Headlines, Peddles Derivatives to Midsize Firms*, WALL ST. J., Nov. 28, 1994, at C1. Nevertheless, at least some institutional investors have been able to resist the urge to invest in derivatives when they did not believe derivatives were appropriate for their portfolio. *Local Heroes, Public Finance Chiefs Are Often Very Boring; That's the Good News*, WALL ST. J., Dec. 8, 1994, at A1.

investment activity may not have a sophisticated internal financial management team. In such circumstances, the institution will presumably rely on a broker, dealer, bank, or another firm acting as such to apprise the institution of investment risks. The institution may even have to depend on a broker, dealer, or bank for advice on the suitability of a particular instrument for the institution, which would require the adviser to assess the institution's particular investment objectives and needs. Such a "dependent" institution would deserve protection from fraud and overreaching, and it might even need the added protection of fiduciary duties.

The existence of "dependent" and "independent" institutions in this sense raises delicate issues as to the appropriate duties of a broker-dealer or other vendor of institutional financial products. For example, with an "independent" institution, it may be practically sufficient for the broker-dealer to provide the institution with a private placement memorandum or summary documentation. In that case, should all of the information in that document be imputed to the institution? This seems to be the thrust of the *Zobrist* holding, but where does that leave the dependent institution that relies on a derivatives dealer for investment advice on the dependent institution's particular circumstances? Finally, should the same standards apply to both the independent and the dependent institutions?

In the absence of a suitability requirement or a contracted advisory role, the basis for an institution's protection would hinge on the application of fiduciary duties and reliance doctrines. The use of those concepts, however, raises a number of difficult questions. What is the scope of such duties? Under what circumstances do they arise? How do courts applying reliance doctrines determine whether an institution was acting in a dependent rather than an independent capacity? How can broker-dealers protect themselves from claims by institutions who are merely disappointed in the results of their investments? The next section offers a proposal to mitigate these problems, which are difficult and persistent because regulators actually confront a spectrum, from adviser-dependent to adviser-independent, of institutional investors.

III. Tackling the Problem of the Unsophisticated Institution

A. *Risk Disclosure Statements*

One effective and fairly simple way to identify the dependent institution and to limit claims by sophisticated institutions who are merely seeking to blame others for their investment losses is to borrow a page from the CFTC's book. The CFTC requires futures brokers to provide

a customer with a one page risk disclosure statement before opening the customer's account. The required risk disclosure statement sets forth specific risks that may be encountered in futures trading and advises customers to assess their own suitability for such trading.¹³⁸ The SEC has taken a similar approach for novice traders in penny stocks.¹³⁹

1. *Proposed Form*

Institutions dealing in exempt derivative instruments and claiming institutional investor status should be required to sign a one-page document describing the obvious risks of trading derivatives or other instruments. A new regulation would be needed to put this requirement into effect. The CFTC, SEC, and banking regulators together would appear to have the authority to implement such a requirement. Nevertheless, legislation may be needed to close any potential gaps in the agencies' authority. Such an effort seems necessary and appropriate in light of the continuing stream of derivative losses.

The regulation or statute requiring this disclosure statement would specifically allocate responsibility. The disclosure document would inform the institution that it could not rely on the broker-dealer, bank, or other vendor of the instrument for a suitability determination or a risk assessment beyond the terms set forth in any offering circular.¹⁴⁰

138. 17 C.F.R. § 1.55 (1994).

139. The SEC penny-stock rules require that prospective penny stock customers be given a standard form disclosure document before engaging in their first transaction. The prescribed disclosure includes a warning that prospective customers should not make a hurried decision and that high pressure sales techniques can be a warning sign of fraud. The disclosure document states that it is illegal for salespersons to promise that a stock will increase in value or is risk free or to guarantee against loss. The document further states that investors should be wary of companies with no operating history, that investors may lose part or all of their investment, that large dealer spreads will prevent an immediate resale of the stock at the same price, and that the stock may fall quickly in value. The disclosure document also describes the broker-dealer's duties to customers, the rights and remedies available to the customers under the federal securities laws, a description of the dealer market for penny stocks, and other matters. 17 C.F.R. § 240.15g-2 and Schedule 15G (1994).

140. A new doctrine emerging under the federal securities laws may have some application here. Courts have held that company profit predictions and other forward looking information predicting future results is material information to investors. Nevertheless, liability will not attach for erroneous predictions if the predictions are accompanied by language that "bespeaks caution" as to their reliability. *See, e.g., Saltzberg v. TM Sterling/Austin Assocs.*, 45 F.3d 399 (11th Cir. 1995); *In re Donald Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993); *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 856-57 (N.D. Cal. 1993), *aff'd in part*, 35 F.3d 1407, 1414-15 (9th Cir. 1994); *Luce v. Edelstein*, 802 F.2d 49 (2d Cir. 1986); *Moorehead v. Merrill Lynch*, 949 F. 2d 243 (8th Cir. 1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *Sinay v.*

Instead, the institution and vendor would be operating in an acknowledged, arm's-length relationship. The institution would be required to draw on its own resources for risk and suitability assessments.¹⁴¹

Alternatively, the institution could simply refuse to sign the disclosure document. By doing so, the institution would lose its accredited investor status under the federal securities laws. The CFTC's exemption from the Commodity Exchange Act exchange trading requirement for derivatives would also be lost, and the Treasury Amendment's exemption for foreign currency transactions would be made unavailable to such an institution. Collectively, the loss of these exemptions should deny the institution access to the over-the-counter derivatives market.¹⁴² Instead, the institution would be limited to the same markets and be given the same level of protection as any other unsophisticated investor.¹⁴³

The proposed risk disclosure statement should be kept simple and short. The statement should recite that the institutional investor understands that investment risks can vary, that some financial instruments have leverage features that can result in losses in excess of the total investment, that some instruments may be illiquid, and that many derivative and other instruments should not be invested in without an analysis of their risk functions and suitability.

The institutional investor would further acknowledge in this statement that it is a sophisticated investor and is responsible for conducting its own analysis of the suitability of the instruments in which it invests. The acknowledgment should state that the institutional investor is responsible for its own investment decisions and for monitoring its own employees

Lamson & Sessions Co., 948 F.2d 1037 (6th Cir. 1991).

A risk disclosure document for institutional investors will bespeak caution about derivatives and make it harder for institutions to claim that they were not given material information about these investments.

141. See, e.g., Jeffrey Taylor & Steven Lipin, *Bankers Trust Faces Inquiry on Derivatives Sales*, WALL ST. J., Nov. 1, 1994, at C1.

142. There is some uncertainty whether the SEC and CFTC have jurisdiction for some over-the-counter derivatives. Nevertheless, they have been fashioning theories for asserting their jurisdiction. See, e.g., *Bankers Trust Settles U.S. Charges on Derivatives*, WALL ST. J., Dec. 23, 1994, at C1; Saul Hansell, *Bankers Trust and U.S. Set Pact on Disclosure of Derivatives*, N.Y. TIMES, Dec. 6, 1994, at A1. In any event, legislation could be adopted to remove any uncertainty.

143. If the institution signed the document, it could not thereafter claim, of course, that it was not a sophisticated investor. See, e.g., *Wright v. National Warranty Co.*, 953 F.2d 256 (6th Cir. 1992) (holding plaintiff and wife accredited investors where they had represented themselves as sophisticated investors, but later claimed that wife was not); *Anastasi v. American Petroleum, Inc.*, 579 F. Supp. 273, 275 (D. Co. 1984) (private offering exception was available where issuer had a reasonable belief as to eligibility of buyer; buyer's actual financial condition was not determinative).

in their trading of the institution's account. The disclosure document should further state that, even where the institution contracts with a third party for investment advice, the third party would bear only such responsibilities as may arise from its agreement with the institution or as recognized by law.¹⁴⁴

The initial risk disclosure statement should be approved by the institution's board. This will assure that the board is on notice of its responsibilities to oversee the institution's investment programs and the trading of its own employees.¹⁴⁵ That duty could not be shifted

144. The risk disclosure statement could be in the following form:

The undersigned investor acknowledges that it is a sophisticated investor and that:

1. The investor is responsible for conducting its own analysis of the risks and suitability of its investments, and the investor is responsible for monitoring the trading of its account by third persons or by its own employees to assure that all trading is properly authorized;
2. The investor may contract in writing with a third party for investment advice or for the trading of its own account. The investor, however, will still remain liable for any losses from its trading. The third party will be liable only for a breach of its written contract, for fraud or other legal requirements;
3. The investor understands that investment risks can vary, that some financial instruments have leverage features that can result in losses that exceed the investor's investment, that some instruments may be illiquid, and that many instruments, particularly derivative instruments, should not be the subject of investment without an analysis by the investor of their operation, functions and suitability;
4. The investor acknowledges that there are substantial risks even where derivative instruments are being used to hedge or limit other risks. These include basis risks and the risk that substantial funds may be required for margin or other obligations on short notice.

145. Institutional losses from derivative instruments have given rise to recommendations that internal controls and management oversight be strengthened. See GROUP OF THIRTY, DERIVATIVES: PRACTICES AND PRINCIPLES I (1993); OFFICE OF THE COMPTROLLER OF THE CURRENCY, RISK MANAGEMENT OF FINANCIAL DERIVATIVES, Circular No. 277 (Oct. 27, 1993). The risk disclosure statement will assure that management is on notice of its obligation to assure adequate controls are in place and that the risks of the instruments are being managed adequately by an outside adviser. See generally John Gapper, *Derivative Users "Lack Adequate Controls of Risk,"* FIN. TIMES, Dec. 6, 1994, at 21.

informally to a third party. The shifting of such responsibility could only be accomplished by a formal written agreement.¹⁴⁶

2. *Scope of Use*

This risk disclosure statement should be provided to non-dealer institutions that are claiming the status of sophisticated investors. The statements should be given to the institution by broker-dealers or other vendors, including banks, that are offering or selling instruments to accredited investors. The statements need not be given for instruments traded or quoted on a commodity exchange registered as a contract market with the CFTC, a national securities exchange, or NASDAQ.

The risk disclosure document should be required for private placements and over-the-counter derivative instruments. A new risk disclosure statement need not be given for each transaction. Rather, the statement should only be required once, at the beginning of the financial relationship, when the institution first begins to deal with the broker-dealer, bank, or other vendor.

3. *Effects*

The most significant effect of the risk disclosure statement will be to put institutional management on notice that it must analyze the institution's investments.¹⁴⁷ The risk disclosure statement should prevent institutions from claiming that they are sophisticated investors and then asserting lack of sophistication when they lose money through investing.

The risk disclosure statement would not insulate a broker-dealer or other purveyor of complex financial instruments from fraud claims. Where there are specific misrepresentations, liability will still exist if causation can be shown. For example, a derivatives dealer who misrepresents the status of a customer's account, as in the case of Bankers Trust, would still

146. To cut paperwork, it would seem administratively appropriate for subsequent statements to be acknowledged by a corporate officer, provided that the board has passed a formal resolution allowing that action by a particular officer.

147. The fiduciary duty of care that directors owe to their shareholders requires that directors inform themselves of the activities of their corporation. The business judgment rule protects directors from liability arising from bad decisions, but not from uninformed ones. *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Norwood P. Beveridge, Jr., *The Corporate Director's Duty of Care: Riddles Wisely Expounded*, 24 SUFFOLK U. L. REV. 923 (1990). The large losses suffered by institutions suggest that at least some of those firms did not use proper care in informing themselves of the enormous risks presented by derivative instruments. They also apparently failed to monitor those instruments once they were placed on the institution's books.

be liable for losses. This means that a risk disclosure document cannot be used as a shield for fraud. Nevertheless, as suggested by *Zobrist*, oral misrepresentations that contradict written statements may not be actionable.¹⁴⁸

In a series of cases, the CFTC has also held that downplaying the language of a risk disclosure statement negates its effects.¹⁴⁹ Such a rule may be appropriate for truly unsophisticated customers. It has less applicability to a sophisticated institution. To the contrary, the institution should be alerted that something is amiss if a broker-dealer supplies oral information that downplays a government mandated warning or that conflicts with a mandated written disclosure statement.

The requirement of a risk disclosure statement will, of course, result in some additional expense and bureaucracy. That burden, however, would be minimal. Institutions trading on an organized futures exchange in the United States are already required to sign as many as twenty documents before they are allowed to trade.¹⁵⁰ They are required to sign far fewer documents in trading over-the-counter derivative instruments, but the risks of those instruments may be no less great than the risks of futures transactions.¹⁵¹

The benefits created by the risk disclosure document outweigh the additional burden it imposes. Most significantly, the risk disclosure statements would serve to put the institution's management on notice of

148. Cf. *Wright v. National Warranty Co.*, 953 F.2d 256 (6th Cir. 1992) (sophisticated, accredited investor could be defrauded under the federal securities laws where he did not have access to information that would have disclosed the fraud).

149. See, e.g., *Reed v. Sage Group, Inc.*, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,943 (C.F.T.C. 1987); *Nyahay v. National Monetary Fund, Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,121 (C.F.T.C. 1986); *Camp v. First National Monetary Corp.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,190 (C.F.T.C. 1986); *Weinberger v. First National Monetary Corp.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,845 (C.F.T.C. 1985), *aff'd*, 819 F.2d 1334 (6th Cir. 1987); *accord*, *McNally v. Gildersleeve*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,006 (8th Cir. 1994). See generally *Harman v. Murlas Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,323, (C.F.T.C. 1992); *Heilman v. First National Monetary Corp.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,307 (C.F.T.C. 1986); *Jakobsen v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,812 (C.F.T.C. 1985).

150. *Feuding Away Their Futures*, *ECONOMIST*, Oct. 15, 1994, at 101.

151. There is no strong current interest in extensive regulation of over-the-counter derivatives. Tim Carrington, *Few Support Any New Rules on Derivatives*, *WALL ST. J.*, Mar. 9, 1995, at C1. Nevertheless, the industry does recognize that there are problems to be addressed. Six firms have voluntarily agreed to provide risk disclosure documents to their customers. Jeffrey Taylor, *Securities Firms Agree to Set Controls on Derivatives*, *WALL ST. J.*, Mar. 9, 1995, at C1.

the danger of these instruments and to remind them of their obligation to assure that the institution's risk management procedures are sufficient to protect the firm.¹⁵² This notice should both cause the institutions to reflect on their responsibilities before embarking on an investment program they do not understand and preclude after-the-fact claims of lack of sophistication. Greater institutional care will result in less litigation and fewer unnecessary losses.

B. *Private Risk Assignment Through Contracts*

In those instances where the institution does not have the expertise to analyze the risk or appropriateness of a particular instrument or group of instruments, the institution could contract specifically for those services. As a competitive matter, the broker-dealer, bank, or other vendor may want to offer such services anyway. In the absence of a written agreement, however, an institution signing the risk disclosure statement would be on its own with respect to legal responsibility for its investment decision.

Increasingly, institutions are finding that their resources are not always sufficient to allow them to analyze and monitor some of the more complex derivative instruments that are being developed on Wall Street. These institutions may need to obtain supplementary expertise to buttress their own analysis. This may be accomplished through the hiring of additional personnel or by contracting with a third party. Institutions are also increasingly turning to their banks and brokers for advice and guidance.¹⁵³

Such arrangements are a responsible way of dealing with risk and should be encouraged. Hiring third parties, however, has its own dangers. The third party may enjoy such latitude that the institution unwittingly assumes excessively risky positions.¹⁵⁴ When things go wrong, the

152. An Australian court has already held that a corporation's board of directors has an obligation to establish systems to monitor the company's trading activities. *AWA, Ltd v. Daniels*, 10 ACLC 929 (N.S.W. 1992). Nevertheless, many companies have not established adequate controls. Conner Middelmann, *Derivatives Control 'Missing,'* FIN. TIMES, Jan. 16, 1995, at 6.

153. *Risk Management, Contracting Out*, ECONOMIST, Oct. 1, 1994, at 96.

154. To cite a few examples, a trader at Barings PLC forced an old and honored institution into receivership in February 1995. See *supra* note 75 and accompanying text. The Kidder Peabody brokerage firm was devastated by the unauthorized trading of one of its employees in 1994, losing over \$350 million from that trading. See *Dismembered*, ECONOMIST, Oct. 22, 1994, at 90; Floyd Norris, *At Kidder, Peabody: Where Trading Went Awry*, N.Y. TIMES, Apr. 19, 1994, at D6; Michael Siconolfi, *Kidder Discloses Phoney Trades, Fires a Trader*, WALL ST. J., Apr. 18, 1994, at A3. Earlier, Merrill Lynch lost some \$377 million from the trading of an employee that had been concealed from

institution may want to blame the dealers or brokers who sold the instruments without revealing the extent of the risk posed by employee actions.¹⁵⁵

This raises important questions concerning risk management and the legal responsibilities of investment advisers. It also raises the issue of how to allocate liability when the institution is parcelling out its risk management responsibilities. At what point does a broker-dealer or bank assume the role of an adviser and become a fiduciary rather than a vendor? What is the scope of an adviser's fiduciary duties?¹⁵⁶ Two cases lend some guidance.

First, in *Holmes v. Wheat First Securities, Inc.*,¹⁵⁷ the CFTC stated that a broker may have a fiduciary obligation to disclose information beyond that in a risk disclosure statement. The amount of disclosure required depends on the nature of the relationship between the customer and the broker. If the broker acts merely as an agent for execution of the customer's order, providing the risk disclosure document normally fulfills the broker's risk disclosure duty. Where the account is controlled by the broker, however, fiduciary obligations may expand, requiring additional disclosures. This approach would be equally useful for institutional risk disclosures.

The second relevant case is *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹⁵⁸ There, the court held that a securities broker did not owe fiduciary duties to a customer unless there was an express advisory contract or the customer was "infirm or ignorant of business affairs."¹⁵⁹ This would be a good rule for institutions. There is no expectation on the part of a broker-dealer that it is acting as a fiduciary for an institution in the absence of a formal agreement or statutory duty. To the contrary, a broker-dealer can expect that the institution will closely analyze the broker-dealer's investment advice. Further, institutions typically require from broker-dealers a reduction in commission fees and markups. Part of the justification for such a reduction is that, in addition to providing high volume, an institution does not require the same care and handling as do

management. Michael Siconolfi, *Talented Outcasts*, WALL ST. J., Nov. 11, 1993, at A1.

155. See *supra* part II.A.2.

156. The liability concern here is not merely theoretical. A Federal Reserve Report found that seven banks had paid some \$130 million to compensate mutual funds for losses from derivative instruments that were purchased upon the advice of the banks. Keith Bradsher, *Treasury to Take Closer Look at Banks with Derivatives*, N.Y. TIMES, Oct. 21, 1994, at D2.

157. [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,823 (C.F.T.C. 1990).

158. 337 F. Supp. 107 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972).

159. *Id.* at 113.

retail customers. If the institutions do demand that they be given the additional services supplied to unsophisticated retail customers, that demand should be made explicit and reduced to writing. Such a demand is a variance from the “normal” relationship between a broker-dealer and an institutional customer, and that variance should be memorialized.

Conclusion

The growth and complexity of new financial instruments have led to concerns that even the most sophisticated institutions cannot appreciate all of the risks that they may encounter in their investment programs. The large losses that have been experienced by institutions investing in over-the-counter derivative instruments lend credence to those concerns. Efforts to shift responsibility for these investments to the institutions’ vendors, however, seem to reverse the regulatory approach that has been developed to accommodate the growth of institutional trading in recent years. By this approach, institutions are considered sophisticated traders which do not need the paternalistic protection accorded to unsophisticated retail customers.

Rather than abandoning that system, it may be best to take a more formal approach to risk allocation. An institution that wants the advantages of being treated as an accredited or exempt investor under the federal securities laws or the Commodity Exchange Act should be required to acknowledge that it is a sophisticated investor. The institution should also be required to acknowledge that, as a sophisticated trader, it is responsible for conducting its own suitability analysis. If the institution is unable or unwilling to make that acknowledgement, then it should be treated as any other retail investor, and it should also lose its accredited or exempt investor status.

In those instances in which an acknowledging institution believes that a particular program or instrument is beyond its expertise, it may contract for advice from a third party. That contract should be in writing, and it should specify the role of the adviser. The contract would impose enforceable obligations on the adviser and could even give rise to fiduciary duties that would increase on a sliding scale as the role of the adviser approached complete discretionary control over the institution’s account.

In the absence of this approach, we are left with a rather anomalous situation in which large institutions demand freedom from burdensome regulations intended for the unsophisticated, while at the same time claiming the protection of those very same regulations when fate turns sour. Institutions seeking this freedom should be required to delineate in

advance those situations in which they are to be treated as sophisticated investors and those in which they are to receive the protection and bear the burdens of the ordinary investor.