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Derivatives Regulation in the Context of the Shingle Theory

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DERIVATIVES REGULATION
IN THE CONTEXT
OF THE SHINGLE THEORY

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[Unsuspecting Institutional Investor:] But how did we lose so much money on this bond already?

[Derivatives Dealer:] Well, you know, the various currencies reflected in the principal redemption formulas have depreciated significantly against the U.S. Dollar since you bought this security several weeks ago. Also, time decay and volatility changes in the foreign exchange markets have decreased the value of the options embedded in the PERLS.

[Unsuspecting Institutional Investor:] What? Tell me again—in plain English this time. What does all that mean?

[Derivatives Dealer:] It means you made a big foreign exchange bet, and you lost.¹

I. INTRODUCTION

Since 1994, there have been various announcements of financial losses involving derivatives.² Despite the publicity of these announcements as signaling a problem with the manner in which financial derivatives are regulated, federal legislators have done little about the possible problem other than shuffle paper around.³ George Soros warned Congress directly that it had an obligation to regulate derivatives because it will be obligated to "preserve the integ-

rity of the system" if there is a "meltdown." One of Soros' concerns in issuing this warning is that derivative instruments are often used to avoid regulation. Although derivatives are "specifically designed to enable institutional investors to take gambles which they would otherwise not be permitted to take," it appears that, because of abusive sales practices of dealers, the investor may not always realize it is taking such a gamble.

This Article focuses on the regulation of derivatives sales practices. Improvement in the regulation of sales practices would help protect the integrity of the system by limiting the opportunity to mislead or otherwise trick derivatives purchasers into making risky bets with other people's money. But who regulates derivatives sales practices? And through what enforcement mechanisms? In answering the first question, Part II of the Article provides background on the jurisdictions of various derivatives regulators. In answering the second question, Part III of the Article elucidates the "Shingle Theory," which is used by the Securities and Exchange Commission (the "SEC") differentiating the SEC from the other regulators. The differences between the regulators is important because it is not yet clear which, if any of the regulators, will regulate the largest segment of the derivatives market that currently remains unregulated. Part IV examines the facts and circumstances of several well-known derivatives cases and analyzes how their out-

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4 See George Soros, Testimony Before the House of Representatives Committee on Banking, Finance and Urban Affairs (April 13, 1994), available in 1994 WL 14185326. George Soros is the brains behind the Quantum Fund, which is "one of the most successful investment entities since the beginning of time." See GEORGE SOROS, SOROS ON SOROS 3 (1995).

5 See Soros, supra note 4, at *6.

6 Id.

7 See, e.g., West Virginia v. Morgan Stanley & Co., 459 S.E.2d 906 (W. Va. 1995). (holding that Morgan Stanley aided and abetted the State of West Virginia in illegally speculating with state fiduciary funds). See also PARTNOY, supra note 1, at 60-61 (relating an account of an insurance company that discovered after losing money that it may have engaged in an illegal trade).
comes might have differed if the shingle theory were applied. Finally, Part V looks at the possible sources of regulation of the derivatives market and concludes that the Commodity Futures Trading Commission, despite the historical absence of the shingle theory in the commodities markets, is the most likely source of a shingle theory in the field of over-the-counter derivatives.

II. THE REGULATORY ENVIRONMENT OF DERIVATIVES TRANSACTIONS

Derivatives regulation is complex and uncertain. The origin of the complexity is the matrix of functional and institutional regulation over derivatives transactions as well as the complexity of the transactions themselves. To understand the complexity of derivatives, it may be useful to have a working definition of them before discussing the uncertainty regarding their regulation. Fundamentally, derivatives are financial instruments whose value is determined by or derived from an underlying reference rate, index, or asset. The more standardized derivatives like

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8 See U.S. GEN. ACCT. OFF., PUB. NO. 98-5, OTC DERIVATIVES: ADDITIONAL OVERSIGHT COULD REDUCE COSTLY SALES PRACTICE DISPUTES 54-55 (1997) [hereinafter 1998 GAO REPORT] (noting that derivatives dealers that are affiliates of securities, futures, and insurance firms do not consider themselves to be regulated entities under the securities laws or the CEA, but that the SEC, the CFTC, or a court could take actions against them based on a determination that a specific product falls within such laws).

commodity futures or stock options generally are traded on exchanges.\textsuperscript{10} For derivatives that are exchange traded, the jurisdictional lines are clear-cut. If a derivative contract is traded on a commodity futures exchange then it is regulated by the Commodity Futures Trading Commission (the "CFTC"). If it is traded on a securities exchange then it is regulated by the SEC.

The regulatory uncertainty lies mainly in derivatives that are not traded on exchanges, where there is subjectivity involved in characterizing a derivatives transaction for jurisdictional purposes. For example, it has been said that whether a derivatives transaction is a security or not depends on who is looking at it.\textsuperscript{11} Even though some derivatives dealers are subject to both functional and institutional regulation, some of the transactions they enter into are subject to no regulation at all. To better understand how this may happen, it is necessary to examine briefly the regulators of the primary derivatives dealers including banks, commodity futures brokers, and securities broker-dealers.

Institutionally, there are four banking regulators that oversee the derivatives activities of banks: the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve System.\textsuperscript{12} In addition, derivatives transactions that involve instruments that fall within the definition of a "security" are regulated by the SEC.\textsuperscript{13} Similarly, such transactions that fall within the definition of "contract for future delivery," that is, a futures contract, are regu-

\textsuperscript{11} See Becker & Fisher, supra note 9, at 1039.
\textsuperscript{13} See 1997 GAO REPORT, supra note 3, at 28-29. See also Chicago Mercantile Exch. v. Sec. & Exch. Comm'n, 883 F.2d 537, 539 (7th Cir. 1989).
lated by the CFTC. But concrete definitions for "security" or "contract for future delivery" are especially elusive and malleable when applied to derivatives contracts. Where derivatives contracts fall outside the purview of the banking regulators and a dealer can argue that it is not a security or a futures contract, the dealer is able to avoid explicit regulation. Meanwhile, although there is no explicit regulation, a court or regulator may be able to assert or deny jurisdiction depending on the circumstances based on these slippery definitions. Indeed, most derivatives transactions fall into this category that is either devoid of regulation or subject to ill-defined regulation. These derivatives are called over-the-counter ("OTC") derivatives.

The effect of this complex web of federal regulation that behaves temperamentally toward a substantial category of derivatives transactions is to leave derivatives buyers without any certainty as to whether they will be protected from unscrupulous dealers. Resolving the uncertainty requires understanding two fundamental methods financial regulators use to govern their respective jurisdictions. First, financial regulators impose minimum capital requirements on financial institutions. Second, they impose liability for deceptive or fraudulent sales practices. According to the Chairman of the Securities and Exchange Commission, this latter method of regulation has generated a great deal of controversy.

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14 See id.
15 See id. at 29. See, e.g., Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1276 (S.D. Ohio 1996) (noting that the derivatives in that case were not regulated).
19 See id.
20 See id.
Although much of the regulation of banks, commodity futures brokers, and securities broker-dealers involves capital requirements, the imposition of capital requirements does not focus on providing a theory of liability to plaintiffs or direct protection of investors. Rather, regulators impose capital requirements on banks, securities broker-dealers, and CFTC registrants (Commodity Trading Advisors ("CTAs") and Futures Commission Merchants ("FCMs")) to insure their continued economic viability, which is only an indirect method of protecting investors. For example, in the context of banking, regulators use capital requirements to safeguard depositors' funds. This means that capital requirements are more likely to prevent a regulated financial institution from buying unsafe financial instruments rather than restricting the sale of such instruments. Sales practice regulation protects investors by providing a theory of liability for plaintiffs and regulators to sue the financial institutions for injuring derivatives end-users.

Banking regulation of sales practices differs greatly from securities and futures regulation of sales practices. For banks, the concern with minimum capital requirements, that a particular bank will be able to continue in its function as a bank, spills over into sales practices. The theory is that if a bank is not dealing fairly with its customers for products and services other than deposits, it will be unable to attract depositors to allow the bank to continue its existence. Because of this concern for the integrity of the banking system, few, if any, private remedies are provided for bad sales practices under banking regulation. As mentioned above, banking oversight is provided entirely by four banking regulators.

In contrast, the securities and commodity futures regulation of sales practices tends to focus on the protection of

21 See 1998 GAO REPORT, supra note 8, at 50-51.
22 See id. at 49-52.
23 See id. at 50-51.
24 See id. at 52.
investors. As a result, investors that purchase securities or commodity futures from entities other than banks can pursue standard remedies under the respective regulatory scheme. Thus, outside the province of banks, a regulator or investor may pursue different theories of liability depending on whether the asset purchased is a commodity futures contract or a security.

The regulation of activities of broker-dealers and CTAs/FCMs can further be differentiated from the regulation of banks by the reliance on self-regulation. The Securities Exchange Act of 1934 ("Exchange Act") and the Commodity Exchange Act ("CEA") both provide for Self-Regulatory Organizations ("SROs"). Currently, the SRO associated with the securities industry is the National Association of Securities Dealers ("NASD"); similarly, the National Futures Association ("NFA") partially regulates the commodity futures industry. The existence of these SROs enables the SEC and the CFTC to oversee a great deal of activity on fairly limited budgets. One of the major functions of the SROs is to provide industry standards to their respective industries, including standards for sales practices. Although both the securities industry and the futures industry have the benefit of SROs, there is an important difference between the two industries: the availability of a shingle theory.

III. THE SHINGLE THEORY

The shingle theory is a regulatory creation developed by the SEC to provide consistent protection to investors purchasing securities from brokers and dealers. Such consistency was necessary because of the similarity from the per-


26 SROs perform regulatory functions for their members subject to supervision by the relevant agency. For a more complete treatment of this form of market regulation as it has developed in connection with securities exchanges, see 6 L. LOSS & J. SELIGMAN, SECURITIES REGULATION 2692-2722 (3d ed. 1990).
spective of the investor between agent and principal transactions. When a stock or bond salesperson sells securities that it does not already own to an investor, it has a fiduciary duty to the investor. This fiduciary obligation arises from the agency aspect of the relationship in a brokerage transaction. Such a fiduciary relationship does not exist when a stock or bond salesperson sells securities that it already owns to an investor, also known as a "dealer" transaction, because there is no agency relationship. Rather, the relationship is between two principals to a transaction similar to buying goods in a retail store. In a retail store setting, the storeowner generally owns the goods he sells to the customer rather than taking the customer's order and purchasing the goods on a market to provide to the customer. Indeed, taking an order in a store and then tracking down goods to fulfill the order may not provide for expedient commerce. If a retail storeowner did business by purchasing the goods for each customer order on an open market, an agency relationship would exist. The customer would easily recognize the difference because in one case, the customer could pick some merchandise off the shelf, take it to the cashier to pay for it, give the cashier money, and walk away with the purchased item. In the other case, the customer would have to order the merchandise from the storeowner and wait for the storeowner to obtain the merchandise before the customer could take it home. The distinction between a dealer and broker transaction is not as easy to recognize for an investor purchasing securities, however, because the investor orders the securities in the same manner for both types of transactions. Then, after an investor places an order for a particular security, the broker-dealer decides how to complete the transaction.

To allege fraudulent sales practices against a securities salesperson who acted as a broker, an investor does not

28 See id. at 218 & 232 n.179.
29 A more complete analogy also may include an advisory role on the part of the retailer.
need to rely on a theory special to securities law. The securities laws provide a great deal of protection to investors when there is a fiduciary relationship. But an investor that buys the security from a salesperson whose firm already owns the stock — i.e., a dealer rather than a broker transaction — will have a difficult time suing for fraud without a duty imposed on the salesperson that is special to securities law. This conclusion is true even though the investor may not be able to tell the difference. This gap in duties in the securities context is filled by the shingle theory.

Under the shingle theory, a dealer is held to an implied representation that it will deal fairly with customers to whom it sells securities. A failure to deal fairly with a customer is a breach of this duty, giving rise to the same fraud causes of action available against a securities broker. The basic rationale behind the theory is that a securities dealer is "under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance." The shingle theory is important because without it, the SEC would not be able to apply sales practice theories to both broker and dealer transactions. Similarly, it could provide a valuable theory to assist regulators and aggrieved OTC derivatives purchasers. When a derivatives transaction is effected on a securities exchange, the duty already applies. However, for off-exchange transactions or transactions on a futures exchange, the shingle theory duties do not currently apply.

30 See Markham, supra note 27, at 227-34.
32 See Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943). See generally Karmel, supra note 31; Loss, supra note 31.
33 Charles Hughes & Co., 139 F.2d at 437. See generally Karmel, supra note 31; Loss supra note 31.
34 See Charles Hughes & Co., 139 F.2d at 437. See generally Karmel, supra note 31; Loss supra note 31.
The sales practice theories of liability hinging on the shingle theory could provide effective protection to end-users of derivatives. In the securities context, three types of obligations have developed that could be applied to derivatives dealers under the shingle theory. First, dealers are obligated to charge a price for a security that will bear a reasonable relationship to the market price of the security. Second, dealers are prohibited from marking up the price of a security excessively. Finally, dealers are prohibited from recommending securities that are not suitable to the investor's investment strategy.

A. Reasonable Pricing

In 1939, the SEC first advanced the shingle theory in the administrative case, *Duker & Duker*. In that case, the Commissioners revoked the registration of a broker for selling securities for prices that had no relation to their market value. The broker, William T. Duker, Jr., purchased securities for the firm's own account for $1,045. After a lapse of time during which the market for the securities remained stable, the dealer sold the same securities to his own customer for $1,506.65 knowing full well that the customer would not know the difference. The order written by the Commission also addressed a similar transaction involving prices lacking relation to actual value. In its written opinion, the Commission stated that it is "neither fair dealing, nor in accordance with [the standards of the profession], to exploit trust and ignorance for profits far higher than might be realized from an informed investor."
Therefore, the Commission found that the acts of Mr. Duker violated the antifraud provisions of the Exchange Act. Therefore, the Commission found that the acts of Mr. Duker violated the antifraud provisions of the Exchange Act.

B. Excessive Mark-ups

A few years later, the shingle theory was affirmed outside the Commission by the Second Circuit in Charles Hughes & Co. In that case, a broker-dealer appealed the Commission's revocation of its registration for charging excessive mark-ups on securities. Essentially, the violations of the antifraud provisions were similar to the violations in Duker & Duker except that the prices were not as unrelated to the market price. In Duker & Duker, the two transactions discussed by the Commission pocketed the broker a return of 44% and 56%. In Charles Hughes, the broker-dealer marked up the prices of the securities ranging from 16% to 40% across various transactions with "single women and widows." The court agreed with the SEC that dealers have a duty to disclose the true market price of a security. This special duty not to exploit customer ignorance of market values arises, the court held, because of dealer's "expert knowledge and proffered advice." The rationale that the court asserted was that "[t]he essential objective of securities legislation is to protect those who do not know market conditions from the overreaching of those who do." Duker & Duker and Charles Hughes are old cases. Nonetheless, a case decided in 1996 in which the SEC was the plaintiff, demonstrates that the theory still applies. In

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43 Id. at 388-89.
44 See id. at 387-88.
45 Charles Hughes & Co., 139 F.2d at 434.
46 See Duker, 6 S.E.C. at 386 (Return = profit / initial investment; Return on transaction 1: 461.65/1045=44%; Return on transaction 2: 206.04/366.18=56%).
47 Charles Hughes & Co., 139 F.2d at 434.
48 See id. at 437.
49 Id.
50 Id.
SEC v. First Jersey Securities, Inc., the Second Circuit affirmed a district court decision finding violations of the antifraud provisions of the securities laws for, \textit{inter alia}, excessive mark-ups. The transactions at issue in the case were between a broker-dealer and "hundreds of thousands" of its customers with whom the defendant traded securities for its own account. By dealing in OTC securities, the defendant found that it was able to sell a new issue of securities, buy it back at a slightly higher price, then repackage the securities and mark them up as much as 150%. Because there was little liquidity in the market for the securities, that is, not enough trading activity to for a market price to be established, the defendant was able to set the price however it wanted with its customers.

Interestingly, the salespeople working for the defendant had no idea what was occurring because of an elaborate scheme developed by the defendant. The registered representatives adhered to a strict cyclic selling plan that was directed by the defendant and consisted of three parts. During two weeks of the month, salespeople would cold call or, basically, look for new victims. After finding people that showed an interest in buying a security that the firm recommended, the branch manager would have the salespeople spend a week informing potential customers identified in the first phase that the research department was about to recommend a security. During this phase, the customer would be asked how much money it would invest in such a security. In the final week of the cycle, the salespeople would be given the name of the security to recommend.

\begin{footnotes}
\item[51] 101 F.3d 1450 (2nd Cir. 1996).
\item[52] See id. at 1457, 1459.
\item[53] See id. at 1456-59.
\item[54] See id. at 1471.
\item[55] See id. at 1458.
\item[56] See id. at 1456-57.
\item[57] See id. at 1457.
\item[58] See id.
\item[59] See id.
\end{footnotes}
On the face of it, this appeared to be a pretty effective selling program to the salespeople who profited greatly from it. The salespeople did not realize, however, that they were participating in their employer's elaborate scheme of gouging customers by selling, purchasing, repackaging, and reselling the securities. Management hid this from the representatives by preventing them from talking to counterparts at other branches run by the defendant. Had a salesperson done so, he might have discovered that he was selling a stripped-down version of a security for the same price that a salesperson at another branch had sold the month before. It was not difficult to control the representatives in this manner because they generally had no prior experience before working for the defendant. Additionally, the salespeople were never informed of the risks involved with the securities nor were they allowed to conduct research concerning the securities.

The court held that a broker-dealer impliedly represents to customers that the prices charged to the customer for securities transactions "are reasonably related to the prices charged in an open and competitive market." An interesting aspect of this case that relates to OTC derivatives is that the securities at issue were purchased and sold over the counter rather than on an exchange. In transactions off-exchange in an instrument that is thinly traded, it is difficult to value the financial instruments because the price may not be established competitively. The court in this case had to determine the reasonable price for the security just as a court would have to for OTC derivatives.

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60 See id.
61 See id.
62 See id. at 1471.
63 See id. at 1456-57.
64 See id. at 1457.
65 Id. at 1469.
66 See id. at 1456.
67 The mechanisms that courts use to value securities and derivatives are beyond the scope of this Article.
C. Unsuitability

Just as the shingle theory imposes a duty to disclose excessive mark-ups, it also imposes a duty on a dealer to disclose the unsuitability of its own recommendations. Two different approaches have emerged regarding the elements of a suitability case. The first approach, applied by the Second Circuit in *Brown v. E.F. Hutton Group, Inc.*, requires a plaintiff to prove that (1) the defendant knew or reasonably believed that the investment was unsuitable, (2) the investment was in fact unsuitable, (3) the defendant recommended or purchased it anyway, (4) he represented that it was a good investment (or, owing a duty to the buyer, failed to disclose that it was unsuitable), and (5) the plaintiff justifiably relied on the representation. In that case, investors were sold oil and gas limited partnerships for which the prospectus included clear and plain language regarding the risks involved in the investments. The plaintiff investors claimed that they were told that the investments were of suitable risk but the court held that investors cannot rely on such oral representations if they are in conflict with the documentation prepared for the purpose of disclosure, in this case the prospectus. Investors, at the minimum, should read these materials.

A second approach to suitability claims was adopted by the Tenth Circuit in *O'Connor v. R.F. Lafferty & Co.* To prove that an investment is unsuitable in that circuit, a plaintiff must show that (1) the broker recommended (or purchased in the case of a discretionary account) securities

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70 See id. at 1029.

71 See id. at 1031.

72 See id. at 1032.

73 965 F.2d 893 (10th Cir. 1992).
that were unsuitable in light of plaintiff's objectives, (2) the recommendation was made with an intent to defraud or with reckless disregard for the investor's interests, and (3) the broker exercised control over the investor's account.\footnote{See id. at 898.} In the O'Connor case, a woman left "virtually all" of her assets to be managed by an investment advisor who knew that she needed a minimum amount of income from the assets.\footnote{See id. at 895.} The plaintiff alleged unsuitability of oil and gas limited partnerships, as well as equity investments in five companies.\footnote{See id. at 896.} The investment advisor was personally associated with some of the companies of which she alleged were unsuitable investments for her, but she thought his associations with these companies made them less risky.\footnote{See id. at 899.} Eventually, the plaintiff's investments lost $329,000.\footnote{See id. at 896.}

The court held in favor of the defendant because the plaintiff did not prove scienter.\footnote{See id. at 898.} The defendant provided plausible reasons as to why he thought all of the recommendations that he made to Ms. O'Connor were suitable for her needs.\footnote{See id. at 899-900.} Without sufficient evidence from which to infer that he actually believed that the investments were unsuitable, the court could not find that the defendant had the requisite scienter for an unsuitability claim.\footnote{See id. at 900.}

An interesting aspect of both of these suitability cases is that the plaintiff lost. This is important because it shows that suitability requirements for broker-dealers, as they would for derivatives dealers, impose only a very low hurdle. It appears that as long as a dealer is not recklessly or intentionally recommending unsuitable investments, it would satisfy suitability requirements in most jurisdictions. As a result, it would be difficult for derivatives dealers to argue that a suitability requirement is a burdensome impo-
sition. Additionally, the *O'Connor* case required that the broker exercise control over the investor's account. This requirement would be difficult to meet in an OTC derivatives context because relationships between derivatives dealers and end-users rarely involve the same kind of control over a customer's funds as occurred in the *O'Connor* case. Thus, the shingle theory as applied in the Second Circuit would be more appropriately applied to OTC derivatives transactions.

D. Where the Shingle Theory Applies

The shingle theory does not apply to futures transactions or to transactions entered into by banks. One of the differences between banks and securities dealers that could explain why banks have no shingle theory duties is the absence of an SRO in the banking context. It has been posited that the shingle theory stems in part from fair practice guidelines of the NASD. But this does not explain why no analogous shingle theory has developed in the context of commodity futures transactions, because the futures industry is partially regulated by an SRO, the National Futures Association. It is likely that no need for a shingle theory developed for commodity futures transactions because there is little opportunity for a futures salesperson or other registrant to act as a principal in such a transaction. Rather, registrants and persons associated with registrants generally act as brokers. Thus, most of the trades involve an

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agency relationship, giving rise to fiduciary duties. Under Section 4(a)(1) of the CEA, commodity futures transactions between registrants (CTAs and FCMs) and customers depend on fiduciary relationships because they must be, subject to some exceptions, conducted on a Board of Trade. If the registrant is able to subject the transaction to open outcry on a board of trade and is still in the position to take the other side of the transaction as a principal, Section 4b(a)(iv) of the CEA further restricts any opportunity to do so. This section prevents a registrant from taking the other side of a customer's transaction without prior consent, which would be analogous to selling a security from a firm's own inventory. Without the opportunity for registered entities to act as a principal in selling futures contracts to customers, there is little opportunity to charge a "mark-up" unrelated to the market price of the commodity rather than a commission. Thus, with regard to pricing there has been no need to develop a shingle theory for commodity futures transactions.

From a historical standpoint, there has also been no need to develop a shingle theory to impose suitability requirements for futures transactions. The reason for this, however, is not because there is little opportunity for a non-registrant to purchase futures contracts from someone other than an agent. Rather, it is because commodity futures transactions are not subject to suitability require-

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85 See Walter C. Greenough, The Limits of the Suitability Doctrine in Commodity Futures Trading, 47 Bus. Law. 991, 1007 (1992) (observing that customers are protected from brokers under common law fraud, fiduciary duty, and negligence theories).
87 See 7 U.S.C. § 6b(a)(iv) (1994) ("It shall be unlawful . . . for any [registrant] in or in connection with any order . . . for or on behalf of any other person . . . willfully and knowingly and without prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to a buying order from such person.").
88 See supra text accompanying notes 84-87.
ments even where a fiduciary relationship exists. According to one commentator, the reasoning behind the reluctance of the CFTC and courts to impose a duty to recommend suitable futures contracts based on customer characteristics is that for numerous reasons it is more difficult to define suitability in the futures context.

Suitability is often dependent on the goals of the investor. For purchasers of securities, goals may include income production, preservation of capital or speculative growth. To achieve these goals, investors in securities can choose from a broad range of securities that contain various degrees of risk, ranging from virtually riskless United States Treasury Bills to very risky stocks of start-up companies and volatile penny stocks. In contrast, a futures customer will either be a hedger or a speculator with either narrow goals or a narrow choice of contracts in which to trade. The hedgers in the market are the commercial users and producers of commodities that "hedge," i.e., protect themselves, against the risks of price fluctuations in particular commodities. For a commercial user or producer wishing to hedge, the range of choice of contracts to purchase or sell is limited to the commodities it uses or produces. The remainder of the market participants consists of speculators. As the label implies, speculators in futures markets have narrow goals relative to investors in secur-

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89 See Greenough, supra note 85, at 1000; Karmel, supra note 31, at 1276-77.
90 For an excellent explanation of the difficulties in applying suitability requirements in the commodity futures trading context, see Greenough, supra note 85, at 1000-06.
91 See id. at 992.
92 See id.
93 See id. at 991 (citing the National Futures Association Manual (P-H) ¶ 10,060, at 10,072).
94 See Markham, supra note 27, at 200-01. (noting that one of the roles of the commodity futures markets is to provide hedging capabilities to commercial users and producers of commodities (thus, hedgers) and that speculators are necessary to the hedging function of the markets because they provide liquidity and pricing information).
ties —speculators merely wish to speculate on price fluctuations.

An example of a typical commodity futures transaction may assist in clarifying the roles of the participants in commodity futures markets. Assume a farmer is going to produce 500 bushels of corn. Further assume that he has already bought the seeds, fertilizer, and all the other necessary supplies so he knows what his costs are before he plants the seeds. If he knows that it will cost him $100 and that the current price for the 500 bushels is $120, he may be interested in locking in the $20 profit. In order to do so, he can sell a contract for the right to take delivery of the corn in six months for $120. The person that purchases the contract for future delivery of the corn is speculating that the price of the corn will continue to rise, hence the name speculator. Now, if the price goes down it is the speculator that will take the loss, not the farmer. Thus, the speculator has effectively relieved the hedging farmer of the risk that the price will go down, wiping out the farmer's profits. If the price continues upward then the speculator profits. It should be noted that futures contracts generally have a delivery date after which the contract is executed in its entirety.

Because futures contracts have short term expiration dates, an investor that wants to invest money that will ap-

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85 See Mahlon M. Frankhauser, Playing with Political Futures, 5 BUS. L. TODAY 15, 16 (1996) (noting that "[t]he futures markets . . . provide[e] a mechanism to manage or shift risks"); V. Leelakumar Peesapati, Comment, Freedom of Markets or License to Loot: Proposed Commodity Futures Trading Commission Regulation 1.35, 8 ADMIN. L.J. AM. U. 97, 122 & n.134 (1994) ("The purpose of hedging is to guarantee a specific price for a commodity at a future date. The hedger wishes to shift risk by entering into the futures market and securing a price for the commodity the hedger wishes to sell. The speculator, by contrast, wishes to accept the risk shifted by hedgers in the hopes of gaining huge profits.").

preciate in value for a year or 50 years will not be able to achieve that goal in the commodity futures markets. An investor that wishes to generate a stream of income from an investment will not be able to do so in the futures markets. Futures contracts do not generate income. A broker in commodity futures contracts does not have to take these goals into account. Rather, the only determination left is whether the prospective trader has the "capacity to absorb losses." In other words, a person is suitable to trade in commodity futures if this person has money to lose. Presumably, this analysis would not apply to people participating in the market to hedge risks. For a hedging party, it appears that the only determination would be whether there is an actual risk to hedge.

While, as noted above, futures dealers have little opportunity to act as principals in their transactions with customers, OTC derivatives dealers almost by definition act as principals. If a transaction is on a regulated exchange, it will be subject to exchange rules and federal regulation under the Exchange Act or the CEA and thus will not be over-the-counter. Where exchange transactions tend to be standardized, OTC derivatives contracts tend to be individually tailored by or even created by the dealer. Be-

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97 Greenough, supra note 85, at 992.
98 In the 1930's, prior to the enactment of the CEA, a market participant did not have to be alive to meet the "ability to lose money" requirement. See Markham, supra note 27, at 205. ("Many of the individual speculators participating in the futures markets were unsophisticated individuals. For example, the [Department of Agriculture's] survey found that market participants included six dead men.").
99 See supra text accompanying note 84-87.
100 See Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1286 (S.D. Ohio 1996) (noting that the parties to the transaction at issue were both principals). The court also quoted a West Virginia case in support of its finding that Bankers Trust, as a counterparty, was a "principal in the transactions at stake, not a broker." Id. at 1286 (quoting West Virginia v. Morgan Stanley & Co., 459 S.E.2d 906, 913 (W. Va. 1995)).
101 See J. Christopher Kojima, Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying the Federal Securities
cause of this fact, a derivatives dealer would tend to sell the instruments from its own inventory rather than subject to competition through an exchange. Thus, the agency relationship that exists in futures contracts does not exist in the over-the-counter context. It should be noted that OTC derivatives can be tailored to include characteristics of either futures contracts, securities, or both.

IV. CASES INVOLVING DERIVATIVES

Since 1994, various disputes involving derivatives have arisen. This section will describe the cases that have caused the most public concern in the area of derivatives sales practices. The cases that follow involved over-the-counter derivatives, regulated derivatives, as well as instruments that are commonly grouped with derivatives.

A. Orange County

Although the Orange County debacle was very public, there are no court opinions that lay out the relevant facts of the case regarding derivatives. But the incident spurred a great deal of commentary from many sources. One vivid

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Laws to OTC Derivatives, 33 AM. BUS. L.J. 259, 311 (1995) ("OTC derivatives [are] individually negotiated and tailored to the particular end-user.").

102 This section also includes cases that were either perceived by the public to be derivatives claims even though they were not and cases that involved derivatives-like instruments.

example is an account by Frank Partnoy in the book F.I.A.S.C.O. Robert Citron, the treasurer of Orange County, purchased a large number of complex financial instruments on behalf of Orange County basically betting that interest rates would not increase. In order to do so, he employed a great deal of leverage.

Specifically, to place the bets he borrowed about $13 billion to purchase structured notes, trigger notes, and inverse floaters that were tied to interest rates. According to Partnoy, the structures utilized by some of these instruments are so complex that investment banks hire math and computer whizzes with Ph.D.s to create models to value them. Partnoy, himself a "rocket scientist," contrasted the sophistication of the investment banks with Citron. Rather than a Ph.D. in math or computer science, Citron was "a college dropout," "had the math skills of a seventh grader," had "deficiencies in his ability to reason, process information, and discern relevant details," and "suffered from dementia and was a man of limited intellectual capabilities." Partnoy also noted that psychologists who had examined Citron "put his ability to think and reason in the lowest 5 percent of the population." On top of all that, Partnoy noted that Citron wore turquoise jewelry.

A salesperson for Merrill Lynch, Michael Stamenson, appears to have been the largest beneficiary of Citron's ignorance. Merrill Lynch earned almost $100 million in fees through Stamenson's sales of these financial instruments to Orange County from which Stamenson earned

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104 See Partnoy, supra note 1, at 157-68.
105 See id. at 157, 160, 162.
106 See id. at 160.
107 See id. at 161.
108 See id. at 162.
109 See id. at 163.
110 Id. at 163, 168.
111 Id. at 168.
112 See id. at 166.
113 See id. at 158 (referring to Citron's ignorance); see id. at 159 (noting that Citron was Stamenson's best customer).
millions in commissions. Although Stamenson denied that he was an adviser to Citron, he apparently spoke with Citron regularly.

Could Orange County have prevailed with a suitability claim against Merrill Lynch? It is interesting to note that Stamenson may have had the shingle theory in mind when claimed that he was not Citron's adviser. This is because the shingle theory duties can arise out of an advisory relationship, which falls short of a fiduciary relationship. For this analysis, it will be assumed that, as Senator William A. Craven thought, Stamenson was Citron's adviser thus subject to shingle theory duties. It should be noted that this is not necessarily a fair assumption but is undertaken solely for analytical purposes.

Under Brown v. E.F. Hutton, Orange County would have to show that the transactions were in fact unsuitable, that Stamenson knew that the transactions were unsuitable, that he recommended them anyway, that he represented that they were good investments, and that Citron justifiably relied on the representations. Through evidence provided by 20/20 hindsight, Orange County can probably show that the investments were in fact unsuitable. Even though Merrill Lynch only contributed to part of the losses, the County lost $1.7 billion because of its investments in financial instruments through various broker-dealers, and Merrill Lynch was supposedly Citron's primary dealer.

Orange County may be able to show that Stamenson knew or reasonably believed that the investments were un-

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114 See id. at 159.
115 See id. at 167.
116 See Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943).
117 See PARTNOY, supra note 1, at 167 (Senator Craven responded to Stamenson's denial of an advisory relationship with the question, "Well, what the hell were you talking to this man about every day? The weather?") (emphasis in original).
119 See PARTNOY, supra note 1, at 162.
suitable. According to Partnoy, Merrill Lynch had given Citron warnings about pursuing the risky tactics.120

The next question is whether Stamenson actually recommended the investments. There is no direct evidence that Stamenson actually did recommend the transactions. If he merely told Citron what types of transactions the County could enter into, then he was not recommending anything as long as he provided all of the relevant information. All of the relevant information may include information about the riskiest of possible transactions and the safest of possible transactions. For each possible transaction, he would have to provide the worst case scenario, i.e., that the potential to lose hundreds of millions of dollars existed. Looking at what happened, it does not seem likely that Stamenson provided this information. If he had, it is hard to believe that Citron would reasonably have entered into the transactions.

Regarding the justifiable reliance element, if Citron was as ignorant as he was portrayed in Partnoy's book, Merrill Lynch could argue that Citron would have bought the financial instruments anyway. Orange County could have responded that the shingle theory was intended to protect unsophisticated investors, thus giving rise to a duty to disclose that the investments were unsuitable prior to selling them to the investor.121 Nevertheless, there are circumstances where Merrill Lynch would not be under a duty to disclose the unsuitability of the transactions. For example, Citron may have called Stamenson and told him exactly what he wanted to purchase and on what terms. The suitability doctrine probably would not provide relief to Orange County based on this scenario because Stamenson would have been acting as an order taker rather than adviser.122

Also, Merrill Lynch, as noted, claims to have warned Citron. If this is so, then the content of the warnings may

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120 See id.
121 See generally Charles Hughes & Co., 139 F.2d 434.
be of some relevance. If the warnings clearly and unmistakably conveyed all the relevant risks of the trades, it may be off the hook. Recall that the defendants in Brown v. E.F. Hutton were able to demonstrate that they had given warnings in writing through the prospectus. Thus, justifiable reliance could go either way. Although E.F. Hutton prevailed over Brown and the other plaintiffs, there was a written disclosure. Here, the fact that the disclosure was not written makes the issue much more difficult.

B. Bankers Trust

Bankers Trust has had two highly publicized disputes with derivatives clients, one with Gibson Greetings, leading to administrative actions by the CFTC and SEC, and the other with Procter & Gamble Co. According to the United States General Accounting Office ("GAO"), Bankers Trust has been involved in even more disputes than the public is generally aware. In eighteen derivatives sales practice disputes that the GAO reviewed for one of its reports, nine involved Bankers Trust. In one of the cases discussed here, the firm's dispute with Gibson Greetings, Bankers Trust settled regulatory actions with the SEC and CFTC and submitted to their jurisdiction. But when it litigated its dispute with Procter & Gamble, the jurisdictional bases of the two agencies in the Gibson Greetings case were greatly undermined.

123 See E.F. Hutton, 991 F.2d at 1029.
126 See 1998 GAO REPORT, supra note 8, at 72.
1. Gibson Greetings\textsuperscript{127}

The \textit{Gibson Greetings} case illustrates the advantage that derivatives dealers have over customers in the valuation of the financial instruments that they sell. It also provides a foundation for SEC and CFTC jurisdiction over OTC derivatives, though that foundation was later undercut in \textit{Procter \& Gamble}.\textsuperscript{128} In 1991, Gibson Greetings discovered that it had borrowed money at an interest rate that, although it was the prevailing rate at the time of the loan, was above market rates.\textsuperscript{129} Because of this, Gibson sought to refinance the debt and approached various firms including BT Securities, a subsidiary of Bankers Trust, for assistance.\textsuperscript{130} Gibson ultimately chose to do business with Bankers Trust.\textsuperscript{131}

Gibson, on the advice of Bankers Trust, attempted to reduce the interest rates on the debt by entering into twenty-nine separate over-the-counter derivatives transactions.\textsuperscript{132} Because of the leverage associated with some of the transactions, small changes in interest rates caused Gibson to experience dramatic losses over the course of the relationship between the parties.\textsuperscript{133} Throughout the relationship, Bankers Trust used sophisticated valuation techniques, to which Gibson did not have access, in order to determine the value of the instruments.\textsuperscript{134} Much of the bad press that Bankers Trust has received has been because of the representations that its executives made to Gibson based on the valuations that were arrived at through Bankers Trust's valuation models.\textsuperscript{135} Tape recordings of conversations among executives at the firm demonstrated that they were

\begin{itemize}
\item \textsuperscript{127} 1994 WL 711224.
\item \textsuperscript{129} See \textit{BT-SEC}, 58 S.E.C. at 1145.
\item \textsuperscript{130} See \textsuperscript{id}.
\item \textsuperscript{131} See \textsuperscript{id}.
\item \textsuperscript{132} See \textsuperscript{id}.
\item \textsuperscript{133} See \textsuperscript{id}.
\item \textsuperscript{134} See \textsuperscript{id}.
\item \textsuperscript{135} See \textit{PARTNOY, supra} note 1, at 155.
\end{itemize}
misleading Gibson by lying about the value of the derivatives. For example, an executive of Bankers Trust was recorded saying that the firm should use a particular downward move in the market to "chip away at the differential... between what [the value of the derivatives] really is and what we're telling him." An executive was also recorded saying that the people at Gibson "do not understand it [i.e., a derivatives transaction] quite as well as they should... and that's like perfect for us."

Faced with this kind of evidence, regardless of whether or not the SEC and/or the CFTC had jurisdiction over the transactions, Bankers Trust settled with both agencies. The victory for Bankers Trust that came later in Procter & Gamble resulted in a benefit only to the rest of the industry because the firm agreed to subject itself to close scrutiny by the CFTC and SEC in its settlements with the two agencies in the Gibson-based regulatory action.

The jurisdictional basis over the transactions asserted by the SEC was that the instruments were securities. But the SEC's legal analysis did not include an explanation as to how these instruments fit into the definition of securities. There is some question as to whether these transactions were actually securities transactions. Judge Feikens examined similar transactions in Procter & Gamble and, after a detailed analysis, concluded that the transactions in that case did not fall within the definition.

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135 See id. at 156; Loomis, supra note 103.
137 PARTNOY, supra note 1, at 156.
138 Id. at 155; BT-CFTC at *5.
139 See BT-CFTC; BT-SEC, 58 S.E.C. at 1145.
140 See Loomis, supra note 103.
141 See BT-SEC, 58 S.E.C. at 1145 (finding that the financial instruments were securities). See also Chicago Mercantile Exch. v. Sec. & Exch. Comm'n, 883 F.2d 537, 539 (7th Cir. 1989) ("The Securities and Exchange Commission has the authority to regulate trading of securities and options on securities.").
142 See id.
143 See infra text accompanying notes 148-201.
The CFTC's assertion of jurisdiction hinged on the bare conclusion that Bankers Trust was a CTA.\textsuperscript{144} Indeed, in its order of settlement, the CFTC found a violation of Section 40(1)(A) of the CEA, an antifraud provision of the statute that only applies to CTAs, Commodity Pool Operators ("CPOs"), and their associated persons.\textsuperscript{145} As with the SEC's analysis of whether the instruments were securities, actually a lack thereof, the CFTC did not attempt to support its conclusion.\textsuperscript{146} Indeed, the SEC's and the CFTC's assertions are not consistent with each other. Although both agencies did not attempt to define the transactions as both securities and futures transactions, if the instruments were securities rather than futures contracts, as the SEC concludes, then Bankers Trust was not giving trading advice regarding futures contracts. Rather, it was giving advice regarding securities. Thus, Bankers Trust would not fall within the definition of a CTA.\textsuperscript{147} Conversely, if Bankers Trust was acting as a CTA in these transactions, then it would not follow that the instruments were actually securities.

2. Procter & Gamble Co. v. Bankers Trust Co.\textsuperscript{148}

As strong as the case was against them regarding Gibson Greetings, it appeared that Bankers Trust had a strong case from a legal standpoint in Procter & Gamble. In Procter & Gamble's ("P&G's") lawsuit against Bankers Trust, the judge threw out all the state and federal claims based on securities laws and the CEA leaving only a state common law fraud claim under New York law which required a heightened standard of proof.\textsuperscript{149} It was a significant legal victory for derivatives dealers because the judge rejected

\textsuperscript{144} See BT-CFTC at *5.
\textsuperscript{146} See BT-CFTC at *5.
\textsuperscript{148} 925 F. Supp. 1270.
\textsuperscript{149} See id. at 1274-75.
P&G's argument that the derivatives at issue were securities as well as its argument that Bankers Trust was a CTA, which were the jurisdictional hooks in the Gibson case.

At issue in the case were interest rate swap agreements, which were neither securities nor futures contracts according to Judge Feikens. A corporation or other party, in this case Procter & Gamble, will generally enter into an interest rate swap agreement to hedge interest rate fluctuations. The hedging party enters into the agreement with a party that assumes the interest rate risk and charges a fee for the assumption of that risk, in this case, Bankers Trust. In commodity futures trading, the party that takes the other side of a hedge to relieve the hedging party of a market risk is frequently a speculator. But Bankers Trust may not be in the business of speculating. Rather, Bankers Trust probably entered into its own hedging transaction with other banks to offset the risk that it assumed from Procter & Gamble. As mentioned, Bankers Trust entered this transaction in order to obtain the fee rather than benefit from a change in interest rates that adversely affected Procter & Gamble.

The court concluded that the instruments were not securities because they were not investment contracts, instruments commonly known as securities, notes, evidence of indebtedness, or options on securities. Under the Howey

150 See generally Procter & Gamble, 925 F. Supp. 1270.
151 See id. at 1275.
152 See id.
153 See Lynn A. Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation, 81 VA. L. REV. 611, 669 n.181 (1995) ("[S]peculative futures markets in commodities, for example, are believed to allow mutually beneficial exchanges between risk-averse consumers who want to hedge against price changes and speculators who are happy to bear that risk in return for trading profits.").
154 See Loomis, supra note 103. See also PARTNOY, supra note 1, at 57 (giving an example of Morgan Stanley hedging foreign exchange risk it assumed in the sale of a derivatives instrument).
test, an investment is an investment contract and hence a security if, inter alia, it involves a common enterprise.\textsuperscript{166} The derivatives at issue in \textit{Procter & Gamble} involved no common enterprise or "pooling of funds in a single business venture."\textsuperscript{167} Rather, P&G and Bankers Trust were the only two parties to the transactions at issue.\textsuperscript{168} Procter & Gamble argued that the hedging arrangements that Bankers Trust entered into with other banks formed a common enterprise.\textsuperscript{169} But the court dismissed this argument stating that "[h]ow [Bankers Trust] hedged its swaps is not what is at issue . . . [c]ertainly, any counterparties with whom [Bankers Trust] contracted cannot be lumped together as a common enterprise."\textsuperscript{170} Later in the opinion, after analyzing whether the instruments were notes, evidence of indebtedness, or options on securities, the court disposed of the argument that these were "instruments commonly known as securities" by re-applying the \textit{Howey} test.\textsuperscript{171}

After determining that the instruments were not investment contracts, the court went on to apply the \textit{Reves} test and thus determined that the instruments were not notes or evidence of indebtedness.\textsuperscript{172} To determine whether a financial instrument is a note and hence a security, the Supreme Court set out a "family resemblance" test in \textit{Reves}, which includes four factors.\textsuperscript{173} The factors, none of which are conclusive, are: (1) The intent of the parties, (2) distribution to the public, (3) public perception, and (4) sufficient regulation outside the securities laws.\textsuperscript{174} The court disposed of all but the fourth factor. The first factor differentiates

\textit{... option ... on any security ...}, or instrument commonly known as a security.

\textsuperscript{166} See SEC v. Howey, 328 U.S. 293, 298-99 (1946).
\textsuperscript{167} See Procter & Gamble, 925 F. Supp. at 1278.
\textsuperscript{168} See id.
\textsuperscript{169} See id.
\textsuperscript{170} See id. at 1282.
\textsuperscript{171} See id. at 1278-81 (citing Reves v. Ernst & Young, 494 U.S. 56, 64-67 (1989)).
\textsuperscript{172} See Reves, 494 U.S. at 64-67.
\textsuperscript{173} See id.
investment from commercial purposes.\textsuperscript{165} According to the Supreme Court, the issuer of a note intends to raise capital and the investor in the note intends to extract a profit as the holder of the note.\textsuperscript{166} In contrast, commercial intentions generally include shorter-term considerations like sales of goods to consumers and cash flow.\textsuperscript{167}

In the transactions at issue, the court concluded that the scales were fairly well balanced and thus not determinative.\textsuperscript{168} The second factor, distribution to the public, was easily disposed of because these transactions were between Procter & Gamble and Bankers Trust and not readily saleable to other parties.\textsuperscript{169} In analyzing the third factor, public perception, the court acknowledged that the derivatives are often viewed as securities but concluded that Procter & Gamble knew these OTC derivatives contracts were not regulated by the SEC or the CFTC.\textsuperscript{170} Although not conclusive, the fourth factor dealing with sufficient alternative regulation was not met because, as just stated, these transactions were unregulated.\textsuperscript{171} The judge noted, however, that this is a fact intensive analysis leaving open the possibility that less specialized instruments with more liquid characteristics could be construed as securities.\textsuperscript{172}

Judge Feikens rejected Procter & Gamble's argument that one of the swaps was an option on a security.\textsuperscript{173} An instrument is a security if it is an option on a security.\textsuperscript{174} An option on a security would be the right, but not the obligation, to buy or sell a particular security at a particular price.\textsuperscript{175} The court disposed of Procter & Gamble's assertion

\begin{footnotes}
\textsuperscript{165} See Procter & Gamble, 925 F. Supp. at 1278.
\textsuperscript{166} See Reves, 494 U.S. at 66.
\textsuperscript{167} See id.
\textsuperscript{168} See Procter & Gamble, 925 F. Supp. at 1279.
\textsuperscript{169} See id.
\textsuperscript{170} See id.
\textsuperscript{171} See id. at 1280.
\textsuperscript{172} See id.; see also Hu, supra note 103, at 2353.
\textsuperscript{173} See Procter & Gamble, 925 F. Supp. at 1280.
\textsuperscript{175} See Procter & Gamble, 925 F. Supp. at 1280.
\end{footnotes}
because the swaps did not entitle either party to take delivery of a security.\footnote{176}{See id. at 1281.} The court noted that the transactions at issue in the \textit{Gibson Greetings} case were similar to the swap at issue in this option analysis.\footnote{177}{See id.} Even though the SEC asserted jurisdiction over Bankers Trust in that case based on the option aspect to the transaction, that conclusion by the SEC did not control Procter \& Gamble's transactions.\footnote{178}{See id. at 1281-82.}

Thus, the court concluded that the instruments were not securities. Had the court concluded that the instruments were securities, Bankers Trust would have been subject to the registration and disclosure requirements imposed by the securities laws and regulations thereunder.

The analysis of whether the transactions were subject to the CEA and its antifraud provisions followed the "security" analysis, concluding that the transactions were not subject to the CEA or its antifraud provisions.\footnote{179}{See id. at 1284.} One way that the instruments could have fallen within the CEA is if the transactions at issue were within the definition of futures contracts without an exemption, they would have been subject to the CEA's requirement that they be effected on a Board of Trade.\footnote{180}{See id. at 1285.} If the transactions at issue had had to satisfy this requirement, the transactions would have been illegal because they were not conducted on a registered exchange.\footnote{181}{See id.; see also 17 C.F.R. §§ 35.1-35.2 (1998) (containing the swap exemption).} But the CEA contains a swap exemption, which applied to these contracts.\footnote{182}{See Procter \& Gamble, 925 F. Supp. at 1285-86.}

But the exemption did not get Bankers Trust completely out of the woods because the exemption does not apply to the antifraud provisions of the CEA.\footnote{183}{See Procter \& Gamble, 925 F. Supp. at 1285-86.} In addressing the antifraud provisions, the court then concluded that the transactions did not fall within either Section 4b or 4o of
the CEA, which are the two antifraud provisions that Procter & Gamble alleged that Bankers Trust violated. Section 4b of the CEA applies to futures transactions that were "for or on behalf of any other person." Because these were principal-principal transactions between Procter & Gamble and Bankers Trust rather than entered into by Bankers Trust "for or on behalf of" Procter & Gamble, the court held that the transactions were outside of Section 4b.

Section 40 did not apply to the transactions at issue because it only applies to CTAs. The CEA defines a CTA as "any person who . . . advis[es] others . . . as to the value of trading in . . . any contract of sale of a commodity for future delivery made or to be made subject to the rules of a contract market." But because of the swaps exemption, the swaps were not traded on a contract market or subject to the rules of a contract market. Thus, the court concluded that Section 40 did not apply.

Although Bankers Trust avoided liability for these transactions under the federal securities and commodity futures laws, its futures transactions are currently subject to close supervision of the SEC and the CFTC as a result of the Gibson Greetings case. Additionally, the transactions were still subject to state fraud law claims. Under the terms of the International Swaps Dealer Association agreement, the parties chose New York law to govern construction and enforcement of the contract. As a result, the court set forth the standards that would apply to the claims that were not dismissed in the opinion.

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184 See id. at 1286-87.
186 See Procter & Gamble, 925 F. Supp. at 1286.
187 See id. at 1287.
189 See Procter & Gamble, 925 F. Supp. at 1287.
190 See 1997 GAO REPORT, supra note 3, at 79; Hu, supra note 103, at 2337.
191 See Procter & Gamble, 925 F. Supp. at 1289-91.
192 See id. at 1288.
193 See id. at 1289-91.
First, the court noted that no fiduciary relationship existed between the parties under New York law. Under New York law, there is no fiduciary relationship between two parties dealing in an arm's length transaction. Because the parties in Procter & Gamble were dealing at arm's length, no fiduciary relationship existed.

Next, even though there was no fiduciary relationship, the court held that New York law imposes a duty in arm's length contractual relationships to disclose certain information if one party with superior knowledge regarding that information knows that the other party is entering into the contract based on mistaken information. Thus, in the transactions between Bankers Trust and Procter & Gamble, Bankers Trust was required to disclose any material information regarding the transactions. A failure to disclose such information, i.e., information about which Bankers Trust had a duty to disclose, would amount to a fraud on Procter & Gamble. Procter & Gamble had the burden of proving this fraud based on a violation of this duty by the standard of clear and convincing evidence, which is a more difficult burden to meet than a preponderance of the evidence.

The extent that Bankers Trust would have been liable under the higher standard is difficult to determine. After Judge Feikens decided the motion to dismiss they agreed in settlement to release Procter & Gamble from 83% of its liability under the contracts, which was a release of $150 million. The settlement occurred before the facts of the case were litigated so it is also difficult to determine if

194 See id. at 1289.
195 See id. (citing Beneficial Commercial Corp. v. Murray Glick Datsun, Inc., 601 F. Supp. 770, 772 (S.D.N.Y. 1985)).
196 See id.
197 See id. at 1290 (citing Banque Arabe et Internationale D'Investissement v. Maryland National Bank, 57 F.3d 146 (2d Cir. 1995)).
198 See id.
199 See id. at 1291.
200 See Hu, supra note 103, at 2349.
Bankers Trust would have been liable under a traditional suitability analysis.

Where would a shingle theory have fit into this case? Had a federally imposed shingle theory applied to OTC derivatives transactions, two issues of the case may have been decided differently. First, there still would have been a federal claim after determining that the transactions were not securities and not commodity futures. A shingle theory in OTC derivatives would have picked up where the securities laws and the CEA left off. Second, instead of being left with only a state common law fraud theory after determining that no fiduciary relationship existed, the shingle theory would provide heightened protection to Procter & Gamble. Although the sword provided by the shingle theory is not as sharp as that provided when there is a fiduciary relationship, Procter & Gamble would not have had to show fraud by clear and convincing evidence. Rather, shingle theory claims merely have to be proven by a preponderance of the evidence as in civil actions without a heightened burden imposed by New York common law.\(^{201}\)

Additionally, even though Bankers Trust released Procter & Gamble from 83% of its liability, Procter & Gamble still would have benefited more from the opportunity to rely on a shingle theory. With a shingle theory in place, Bankers Trust might have settled before any litigation. This would have saved the expenses of the legal battle and the embarrassment of the public discovering that Procter & Gamble executives were exposing the company to the risks of derivatives transactions.

\(^{201}\) In actions under section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder, as well as other securities laws actions, plaintiffs need only prove the elements of the claim by a preponderance of the evidence. See Herman & MacLean v. Huddleston, 459 U.S. 375, 387-90 (1983). Since actions relying on the shingle theory are often brought under section 10(b) and Rule 10b-5, this lower burden of proof applies. See, e.g., id.; SEC v. First Jersey Securities, Inc., 101 F.3d 1450 (2d Cir. 1996) (excessive mark-up case brought under section 10(b) and Rule 10b-5).
C. West Virginia v. Morgan Stanley & Co.\textsuperscript{202}

Another publicized case involved a dispute between Morgan Stanley and the State of West Virginia (the "State").\textsuperscript{203} This case is important because it illustrates suitability-like principles in the derivatives context.\textsuperscript{204} In the Morgan Stanley case, the State's suitability-like claim of liability was that Morgan Stanley knowingly aided and abetted the West Virginia Consolidated Fund's breach of a fiduciary obligation by entering into transactions involving inverse floaters, reverse repurchase agreements, and options.\textsuperscript{205} As an initial matter, it should be noted that the end-user of the instruments in this case was not the party bringing the lawsuit, which would have been an ordinary suitability theory. Rather, the claim was by the State to whom the Consolidated Fund owed a fiduciary duty imposed by West Virginia statute proscribing speculation with the Fund's money.\textsuperscript{206} The trial court entered a judgment of approximately $50 million and ruled that, as a matter of law, the transactions at issue were speculative.\textsuperscript{207} The Supreme Court of Appeals did not disagree but decided that Morgan Stanley had a right to a jury determination on the speculation issue nonetheless.\textsuperscript{208}

The option transaction can be summarized as follows. On March 10, 1987, the State sold a put option on seven-year Treasury notes with a strike price of $200 million.\textsuperscript{209} Translated, this put option consisted of the right to sell the treasury notes for $200 million; that is, Morgan Stanley

\textsuperscript{202} 459 S.E.2d 906 (W. Va. 1995).
\textsuperscript{203} See Craig & Hume, supra note 124, at 184-85 (describing the background of Morgan Stanley); George A. Schieren et al., Suitability and Institutions, in \textit{Securities Litigation} 1995 732 (PLI Corporate Law & Practice Course Handbook Series No. B4-7112 1995) (same).
\textsuperscript{204} See generally Schieren et al., supra note 203.
\textsuperscript{205} See Morgan Stanley, 459 S.E.2d at 910-11.
\textsuperscript{206} See id. at 911 (citing \textit{W. VA. CODE} § 12-6-12 (1978)).
\textsuperscript{207} See id. at 911-12.
\textsuperscript{208} See id. at 911, 917.
\textsuperscript{209} See id. at 911. However, the court also referred to the option notes as involving ten-year Treasury notes. See id.
acquired the right, but not the obligation, to sell the notes to the State for $200 million if the value of the notes dropped below that price. The way that the State would have made money in this transaction was if the value of the notes had stayed above a certain aggregate price. Had the value stayed above that price, the State would have had a net gain on a fee called a premium, in this case $843,750, that it was paid by Morgan Stanley to purchase the put option.\footnote{A premium is the initial charge for an option. See David J. Gilberg, Regulation of New Financial Instruments under the Federal Securities and Commodities Laws, 39 Vand. L. Rev. 1599, n.42 (1986). The State was paid a premium of $843,750 for the put option. See Morgan Stanley, 459 S.E.2d at 911.} Morgan Stanley, which purchased the put option, made money when the value of the bonds went below $200 million.\footnote{For the sake of simplicity, this statement ignores the option premium.} Every dollar that the value of the notes fell below $200 million was profit to Morgan Stanley because it would be able to sell the notes to the State at a price of $200 million as a result of purchasing the right to do so by paying the premium. On the day that Morgan Stanley exercised the option, the value of the notes was $192,239,690 and the State was required by the agreement to purchase the notes from Morgan Stanley for $200 million. Hence, the difference, $7,620,313, was a gain to Morgan Stanley and a loss to the State.\footnote{See Morgan Stanley, 459 S.E.2d at 911} The net loss for the State and gain to Morgan Stanley was slightly less than that figure because of the premium of $843,750 that Morgan Stanley paid for the option.\footnote{These transactions may illustrate to the reader how a put option operates. In contrast, the transactions in the Bankers Trust cases, discussed above, were sufficiently complex that it was not useful to explain them.} The court complicated the net loss calculation further by including the hypothetical interest that the State could have earned on the premium had it invested the money.\footnote{See id. at 912.}
Morgan Stanley's alleged role in this transaction was, as mentioned, aiding and abetting the Consolidated Fund's violation of fiduciary duties by taking the other side of the trades.\textsuperscript{215} To see the similarity to suitability, recall the elements of a claim under \textit{Brown v. E.F. Hutton}. In that case, the court held that a defendant could be held liable for recommending investments that were unsuitable if the plaintiff could prove that (1) the defendant knew that the investment was unsuitable, (2) the investment was in fact unsuitable, (3) the defendant recommended it anyway, (4) he represented that it was a good investment (or failed to disclose that it was unsuitable), and (5) the plaintiff justifiably relied on the representation.\textsuperscript{216}

Here, to satisfy the first element, the State would have to establish that Morgan Stanley knew the instruments might be speculative and that Morgan Stanley knew that it was illegal for the Fund to speculate.\textsuperscript{217} The State could probably prove that Morgan Stanley knew that the trades might be speculative because as a sophisticated seller of the instruments, it most likely understood that the instruments could be used for speculation. The State probably could have established that Morgan Stanley knew that speculation was illegal by a presumption that people generally know the law — ignorance of the law is no defense.

To satisfy the second element, the trades actually would have to be speculative. Under the trial court's decision, this element would have been established because the trades were found to have been speculative as a matter of law. The third element could be satisfied by the fact that Morgan Stanley actually traded with the fund, which "allow[ed] the State to pursue its aggressive strategy."\textsuperscript{218} The fourth element would be established by the satisfaction of the first two elements coupled with a failure to disclose the fact of unsuitability.

\textsuperscript{215} See \textit{id.} at 910-11.
\textsuperscript{216} See \textit{Brown v. E.F. Hutton}, 991 F.2d 1020, 1031 (2d Cir. 1993).
\textsuperscript{217} See \textit{Morgan Stanley}, 459 S.E.2d at 911 (indicating that speculation by the fund was illegal).
\textsuperscript{218} \textit{Id.} at 910.
The fifth element, justifiable reliance, is more problematic, however, but the State probably would have prevailed. It could be argued that, because the court noted that the Fund was a sophisticated investor, there could not have been justifiable reliance.\footnote{See id. at 914 n.17.} It could also be argued that there was no reliance because the Fund would have engaged in the same trades with other investment banks had it not traded with Morgan Stanley.\footnote{See id. at 920 ("[I]t is true that if Morgan had withdrawn from trading with the State, other houses probably would have continued to trade.").} But under the shingle theory, Morgan Stanley would have had a duty to disclose that the transactions were speculative and therefore illegal under West Virginia law. Had Morgan Stanley disclosed these items to the decision-makers of the Consolidated Fund, it is unlikely that they would have entered into the transactions and risked going to jail. Thus, West Virginia probably would have prevailed had a shingle theory applied.

Although the State obtained relief through its state law claim, laws are not uniform throughout the country. For example, Orange County was not prohibited from entering into speculative transactions, which may explain the reason for the relatively small amount of litigation resulting from that case regarding the sales practices of the dealers. Had a shingle theory applied to OTC derivatives transactions, both the State of West Virginia and Orange County, California may have been amply protected.

D. Banca Cremi v. Alex. Brown & Sons\footnote{132 F.3d 1017 (4th Cir. 1997).}

Banca Cremi is not an OTC derivatives case because it involved Collateralized Mortgage Obligations ("CMOs"), which are a type of mortgage-backed security ("MBS"). An MBS is an example of a derivative instrument within the definition of "security." However, the case is relevant to this discussion because when the GAO investigated sales
practices of OTC derivatives, various parties had similar concerns about the sales practices of mortgage-backed securities and instruments known as structured notes.\textsuperscript{222} Also, because CMOs are within the definition of securities, the plaintiffs brought the shingle theory claim that this Article argues could be applied to OTC derivatives.\textsuperscript{223} Additionally, the environment in which the transactions took place more closely replicates that of OTC derivatives transactions than the environment in traditional shingle theory claims because these were derivatives although not OTC derivatives.

An important aspect of this case for present purposes is that the plaintiff lost its summary judgment motion based on these shingle theory claims. Specifically, the plaintiff's federal claims were for recommending unsuitable investments and charging excessive mark-ups, both under Section 10(b) of the Securities Exchange Act of 1934.\textsuperscript{224} The dismissal in this case illustrates that although the shingle theory can provide a viable theory of liability for an aggrieved derivatives buyer to sue an unscrupulous derivatives dealer, it does not provide insurance against taking market risks. This means that there is little danger that a shingle theory of liability will give a buyer an unreasonable amount of power over the seller. If a derivatives buyer makes a mistake in judging the market, and the dealer acts responsibly by making sure the buyer understands all the relevant risks and costs in purchasing the derivative instrument, then the buyer may not use the shingle theory to blame the dealer for its own mistake.

In\textit{Banca Cremi}, the defendant was Alex. Brown & Sons, a registered broker-dealer based in Baltimore, Maryland ("Alex. Brown").\textsuperscript{225} The plaintiff was a Mexican bank, Banca Cremi (the "Bank"), that purchased CMOs from the defendant.\textsuperscript{226} In 1994, the CMO market plummeted, leaving the

\textsuperscript{222} See 1998 GAO REPORT, supra note 8, at 2.

\textsuperscript{223} See\textit{Banca Cremi}, 132 F.3d at 1034-35 (acknowledging the shingle theory in discussing excessive mark-ups).

\textsuperscript{224} See id. at 1032-34.

\textsuperscript{225} See id. at 1021.

\textsuperscript{226} See id.
Bank with losses on six of its CMO purchases, a minority of its purchases from the defendant.\textsuperscript{227} Between 1992 and the market drop in 1994, the Bank had earned about two million dollars on CMOs it had purchased from Alex. Brown. When the market turned against it in 1994, the Bank lost twenty million dollars.\textsuperscript{228}

The Bank's asset base on June 30, 1993, which was roughly in the middle of time period that the relevant events had taken place, was approximately $5 billion.\textsuperscript{229} In addition to its large asset base, the Bank had employees that were educated and experienced in various fields of economics and investments managing that asset base.\textsuperscript{230} For example, two of the individuals that oversaw investments for the Bank had economics degrees.\textsuperscript{231} One of these economics-trained individuals even taught economics prior to joining the Bank.\textsuperscript{232} The other person had post-graduate education in international commerce and analysis.\textsuperscript{233} Prior to ever actually purchasing CMOs, the Bank developed a manual detailing a review process for analyzing prospective CMO purchases.\textsuperscript{234}

For the unsuitability claim, the court laid out the five elements applied in Brown v. E.F. Hutton but focused heavily on justifiable reliance.\textsuperscript{235} Originally, the Bank had told Alex. Brown that the criteria for prospective securities purchases were fourfold: (1) "low risk to capital," (2) high liquidity, (3) short term, and (4) "good yield."\textsuperscript{236} The court felt that the Bank was a sophisticated investor and, as a result, was presumed to know about the risks of the instruments.\textsuperscript{237} Because of the sophistication of the Bank re-

\textsuperscript{227} See id. at 1023.
\textsuperscript{228} See id. at 1026.
\textsuperscript{229} See id. at 1023-24.
\textsuperscript{230} See id. at 1024.
\textsuperscript{231} See id.
\textsuperscript{232} See id.
\textsuperscript{233} See id.
\textsuperscript{234} See id.
\textsuperscript{235} See id. at 1028-31.
\textsuperscript{236} Id. at 1024.
\textsuperscript{237} See id. at 1031.
garding these particular instruments, the court apparently did not think it appropriate for the Bank to research the risks of the securities independently and then blame Alex. Brown when the securities after the fact failed to meet its criteria.\textsuperscript{238} Indeed, the court noted that the Bank must have determined that the yield was more important than the other three factors.\textsuperscript{239}

In analyzing the excessive mark-ups claim, the court noted seven factors bearing on the excessiveness of mark-ups: (1) the type of security, (2) the availability of the security in the market, (3) the price of the security, (4) the amount of money involved in the transaction, (5) disclosure, (6) the pattern of mark-ups or mark-downs, and (7) the nature of the investor's business.\textsuperscript{240} Then the court took note of the existence of a shingle theory duty to charge "a price which bears a reasonable relation to the prevailing market or disclosing such information."\textsuperscript{241} After laying out these factors and noting the shingle theory duty, however, the court ignored them and analyzed the case using the elements of a securities fraud claim under Rule 10b-5: (1) a material misrepresentation or omission, (2) scienter, (3) justifiable reliance, and (4) proximate cause.\textsuperscript{242}

The court may have made a mistake by applying the "justifiable reliance" element of a Rule 10b-5 claim to this case. Rule 10b-5 makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact . . . in connection with the purchase or sale of any security."\textsuperscript{243} Thus, the court failed to recognize that there are two types of securities fraud claims under the rule: Those involving an affirmative misstatement and those involving an omission 'to state a material fact. An omission case is

\textsuperscript{238} See id.

\textsuperscript{239} See id. at 1033.

\textsuperscript{240} See id. (citing 3C HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW, App. 12.13 (1992)).

\textsuperscript{241} Id. at 1034 (citing Trost & Co., 12 S.E.C. 531, 535 (1942)).

\textsuperscript{242} See id. (citing Cooke v. Manufactured Homes Inc., 998 F.2d 1256 (4th Cir. 1993)).

\textsuperscript{243} 17 C.F.R. § 240.10b-5(b) (1999) (emphasis added).
necessarily different from an affirmative misstatement case. Where a dealer omits a material fact, such as an excessive mark-up, it has made no statement or representation on which the purchaser could have relied. As a result, instead of requiring that a plaintiff prove subjective reliance in an excessive mark-up claim, courts merely require a plaintiff prove that the mark-up was objectively unreasonable.\textsuperscript{244} Courts arrive at this result by presuming reliance.\textsuperscript{246} The court noted but refused to follow precedent in its own circuit holding that reliance is presumed in omission cases\textsuperscript{246} and failed to even acknowledge similar Supreme Court precedent.\textsuperscript{247} Notwithstanding that it was compelled to apply the presumption that the Banca Cremi relied on Alex. Brown's omissions, the court felt "acutely uncomfortable" in doing so.\textsuperscript{248}

Although it is clear that this presumption could be rebutted by proof that an investor would have purchased the securities even if it knew of an unreasonable mark-up,\textsuperscript{249} the court felt that the presumption was rebutted by the policy surrounding common law fraud, even though there was no evidence that the Bank would have purchased the securities had such a disclosure been made.\textsuperscript{250} Proving fraud, the court noted, requires a heavy burden on the plaintiff, because "the existence of actual fraud is not deducible from facts and circumstances which would be equally consistent


\textsuperscript{245} See Affiliated Ute Citizens, 406 U.S. at 153-54; SEC Amicus Brief, supra note 244, at 17.

\textsuperscript{246} See Banca Cremi, 132 F.3d at 1035 (citing Edens v. Goodyear Tire & Rubber Co., 858 F.2d 198, 207 (4th Cir. 1988)).

\textsuperscript{247} Compare SEC Amicus Brief, supra note 244, at 18 n.13 (citing Affiliated Ute Citizens, 406 U.S. at 153-54), with Banca Cremi, 132 F.3d at 1035.

\textsuperscript{248} Banca Cremi, 132 F.3d at 1035.

\textsuperscript{249} See SEC Amicus Brief, supra note 244, at 18 n.13; Banca Cremi, 132 F.3d at 1036.

\textsuperscript{250} See Banca Cremi, 132 F.3d at 1030.
with honest intentions.\textsuperscript{251} What the court said is true, but it ignores the Supreme Court directive that omission cases are to be treated differently.\textsuperscript{252} The court also included testimony that it felt rebutted the presumption that the Bank relied on the defendant's omissions.\textsuperscript{253} The point of the testimony was that the Bank expected the defendant to earn a profit from the transactions and entered into them anyway.\textsuperscript{254} How does this rebut the presumption? It does not. To rebut the presumption, the testimony would have had to demonstrate that the Bank expected the defendant to earn an \textit{unreasonable} profit yet entered into the transactions anyway. The testimony did not address the reasonableness of the mark-ups.

This critique of the Fourth Circuit decision is included for two reasons. First, the dismissal of the claim for unsuitability provides a lesson similar to that in \textit{O'Connor v. R. F. Lafferty & Co.} and \textit{Brown v. E.F. Hutton Group, Inc.}: It illustrates that it is unlikely the shingle theory will allow derivatives end-users to cripple dealers with unwarranted lawsuits. Second, the dismissal of the excessive mark-up claim illustrates that there is uncertainty in how standards will be applied in shingle theory cases involving derivatives. For example, some circuit courts of appeals, because of the unique facts of a derivatives case, may find equitable reasons to avoid applying presumptions fundamental to securities regulation.\textsuperscript{255}

\textsuperscript{251} \textit{Id.} at 1036 (quoting \textit{White v. National Steel Corp.}, 988 F.2d 474, 490 (4th Cir. 1991) (applying West Virginia law)).
\textsuperscript{252} See SEC Amicus Brief, \textit{supra} note 244, at 18 n.13; \textit{Banca Cremi}, 132 F.3d at 1036.
\textsuperscript{253} See \textit{Banca Cremi}, 132 F.3d at 1036-37.
\textsuperscript{254} See \textit{id.} at 1036.
\textsuperscript{255} Compare \textit{Banca Cremi}, 132 F.3d at 1035 (failing to apply a presumption that a security purchaser relied on a broker-dealer's material omission where the purchaser was a sophisticated derivatives end-user attempting to satisfy the elements of a Rule 10b-5 claim through inferences and presumptions), \textit{with Affiliated Ute Citizens}, 406 U.S. at 153-54 (holding that, in a Rule 10b-5 claim, a security purchaser's reliance is presumed where a seller omits to state a material fact).
V. ANALYSIS OF DERIVATIVES REGULATION IN THE CONTEXT OF THE SHINGLE THEORY

From the discussion in Part III, the reader should be aware that a consistent application of the shingle theory would brighten the gray lines that currently determine jurisdiction and the applicable law in derivatives transactions. While this Article does not conclude application of the shingle theory is necessary or even that it is a good idea, it develops the tools for analyzing this problem. In addition, assuming application of the shingle theory to derivatives transactions is a good idea, the possible sources for shingle theory application still need to be discussed. Possible sources include legislators, administrative agencies (chiefly the SEC and CFTC), and the industry itself in some form of self-regulation. Oddly enough, in light of the lack of a historical precedent for the shingle theory in connection with futures, the CFTC is probably the most likely to provide the shingle theory.256

A. Legislative Endeavors and the GAO Report

Since 1994, there have been various legislative, regulatory, and self-regulatory efforts in the area of derivatives transactions. For example, the legislature has been active in attempting to address concerns that a large segment of the derivatives market is unregulated; but the attempts have been unfruitful. In 1994, Congress considered six bills concerning derivatives, none of which passed.257 Between 1994 and June of 1996, four more bills were introduced and referred to committees.258 But interest in pursuing further legislation will probably wane, because the 1998 GAO Report concluded that no new legislation is needed at this time.259

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256 See Part V.C infra.
257 See 1997 GAO REPORT, supra note 3, at 31-32.
258 See id.
259 See 1998 GAO REPORT, supra note 8, at 141.
The GAO has been busy as well. Since 1994, it has published three major reports. Most recently, the GAO reported its investigation of sales practices of transactions involving derivatives, mortgage backed securities, and structured notes. The report laid out the current framework for regulation, reviewed some of the disputes that have occurred, discussed findings from a survey it conducted in 1995, and made recommendations based on the entire investigation.

The report is informative, yet the survey it conducted in 1995 regarding sales practices may have an inherent flaw. The survey asked end-users to rate the sales practices of derivatives dealers, both those with whom the end-user chose to enter into transactions and those with whom the end-user chose not to enter into transactions. Among the elements of the sales practices the users were asked to rate were the "suitability of the products proposed" and the "competitiveness of pricing and fees." This is ironic because unsuitability and excessive mark-ups are theories of liability based on fraud. If the end-users had been successfully defrauded, there would be no possible basis for rating the suitability of the proposed products or whether the price charged by the dealer was competitive. It is difficult to criticize the GAO in this effort, however, because it would be impossible to determine the extent of fraudulent sales practices engaged in by dealers without asking the dealers themselves.

Interestingly, a former derivatives salesperson, Frank Partnoy, recently published a book that describes the dealer's view of the transactions. An interesting point from this book that highlights a problem with the GAO sur-

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260 See 1998 GAO REPORT, supra note 8; 1997 GAO REPORT, supra note 3; 1994 GAO REPORT, supra note 9.
261 See 1998 GAO REPORT, supra note 8, at 141.
262 See id at 176–89 (reproducing the text of the survey distributed to derivatives users).
263 See id.
264 Id.
265 See PARTNOY, supra note 1, at 55.
vey is the duration of the transactions. For example, the introductory passage to this Article is a quote from the book describing a particular PERLS transaction. PERLS, short for Principal Exchange Rate Linked Security, is a form of structured note sold by derivatives salespeople. According to Mr. Partnoy, derivatives salespeople like to sell them because doing so is like setting a time bomb: "Selling a five-year PERLS to a widow or orphan buyer meant that you didn't have to worry about the repayment of principal for five years—an entire career on Wall Street." At the time the GAO conducted the survey in 1995, there may have been many time bombs that had been set but had not yet detonated. Indeed, the End-Users of Derivatives Association stated in its comment on the GAO Report that "there have been more disputes between end-users and dealers regarding sales practices than may have been aired publicly."

As a result of the survey, the GAO made an extremely interesting finding. Apparently, there is some divergence in perceptions of the relationship between dealers and end-users of derivatives. The derivatives dealers appear to believe that they owe no fiduciary duty to the end-users. In contrast, the end-users believe that the dealers owe them a fiduciary duty. A similar gap in perception, though not identical, is what led to the shingle theory in the securities context. Recall that from an investor's perspective, it is difficult to tell the difference between a dealer transaction and a broker transaction. When a security is purchased from a broker it creates a principal-agent relationship, giving rise to fiduciary duties. However, when the security is pur-

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266 See id.
267 Id. at 60. See also id. at 172 (describing a derivative trade as a "financial time bomb").
269 See id. at 84.
270 See id. at 89 (noting that two industry guidelines, including the FRAMEWORK FOR VOLUNTARY OVERSIGHT, see infra note 279, assert an arm's length relationship rather than a fiduciary relationship).
271 See id. at 84.
chased from a dealer's inventory, no fiduciary relationship is created so the investor is left unprotected unless the shingle theory applies to the transaction.\footnote{272}{See Part III supra.}

This disparity in perception may not lead to an extension of the shingle theory in the derivatives context because it does not involve an alternative hidden scenario that would leave an investor unprotected. Rather, the transactions that are regulated are effected in a drastically different way than unregulated ones. If a derivatives transaction involves a security or futures contract, it will either be accompanied by a registration statement (a security) or transacted on a designated exchange (a futures contract) unless the particular instrument is exempted from regulation.\footnote{273}{See CEA § 4(a)(1), 7 U.S.C. § 6(a)(1) (1994) (requiring commodity futures to be traded on a board of trade in the absence of an exemption); Securities Act § 5, 15 U.S.C. § 77e (1994) (requiring registration of securities (unless another provision or regulation exempts the security or transaction from section 5)).} Some of the exemptions from one of the regulatory regimes exist to allow exclusive jurisdiction of another agency thus avoiding overlap.\footnote{274}{See Kojima, supra note 101, at 307-08.} For example, swaps are exempted from the CEA so that the SEC can have jurisdiction over them.\footnote{275}{See Concept Release. See CEA § 4(a)(1), 7 U.S.C. § 6(a)(1) (1994) (requiring commodity futures to be traded on a board of trade absent an exemption); Procter & Gamble v. Bankers Trust Co., 925 F. Supp. 1270, 1279 (S.D. Ohio 1996) (holding that securities must be registered absent an exemption).}

There are telltale signs that an instrument is unregulated. If there is no registration statement and the transaction is not on an exchange, unless the seller is violating securities laws or the CEA by engaging in the transaction in this manner, it is probably unregulated.\footnote{276}{See CEA § 4(a)(1), 7 U.S.C. § 6(a)(1) (1994) (requiring commodity futures to be traded on a board of trade absent an exemption); Procter & Gamble v. Bankers Trust Co., 925 F. Supp. 1270, 1279 (S.D. Ohio 1996) (holding that securities must be registered absent an exemption).} However, either one of the agencies could assert jurisdiction after the deal goes awry and pressure the dealer into settlement by the
threat of costly litigation.\textsuperscript{277} Regardless of the improbability that this disparity in perception will actually lead to the application of the shingle theory in derivatives transactions, if the shingle theory were applied to derivatives deals, it appears that it would clarify relationships without imposing heavy burdens on the dealers. Regarding this matter, the GAO recommends that the market participants should decide whether the transactions should be considered arm's length, which would not give rise to a shingle theory, or advisory, which would be consistent with a shingle theory.\textsuperscript{278}

The GAO report also recommended, \textit{inter alia}, that the Chairpersons for the SEC and the CFTC, "establish a mechanism for determining that participating firms are following the sales practice provisions of the \textit{Framework for Voluntary Oversight}.\textsuperscript{279}

B. Self Regulation and the Framework for Voluntary Oversight

The \textit{Framework for Voluntary Oversight} ("Framework") is a document drafted by the bulge bracket derivatives dealers, calling themselves the Derivatives Policy Group ("DPG") for this endeavor, in conjunction with the SEC that sets forth a plan of voluntary reporting and self-regulation.\textsuperscript{280} The \textit{Framework} has a fitting title — it is what it says it is. The DPG, which consists of CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Salomon Brothers (now Salomon Smith Barney), agreed that each dealer would report various aspects of its operations that are important to its own

\textsuperscript{277} See 1998 GAO REPORT, supra note 8, at 55. See also \textit{In re BT Securities Corp.}, CFTC Docket No. 95-3 (1994); \textit{In re BT Securities}, 58 S.E.C. 1145 (1994).

\textsuperscript{278} See 1998 GAO REPORT, supra note 8, at 138.


\textsuperscript{280} See DERIVATIVES POLICY GROUP, supra note 279, at 1-4. See also 1998 GAO REPORT, supra note 8, at 88-92.
survival to the SEC.\textsuperscript{231} The self-imposed requirements are similar to banking regulations in that they appear to be concerned with capital requirements and internal controls.\textsuperscript{232}

The Framework also includes a section providing aspirational guidance for the firms' sales practices.\textsuperscript{233} Although it appears that the DPG was willing to agree to protect itself, it was not willing voluntarily to provide protection to end-users. This section dealing with sales practices is carefully worded to avoid creating any legal obligations to purchasers of the derivatives as indicated in its overview paragraph which clearly states that "these guidelines . . . are not intended to prescribe legal standards."\textsuperscript{234} DPG engaged in more subtle efforts to avoid causing duties to attach to its members as well. The DPG avoided the likelihood that fiduciary duties would be created inadvertently in two main ways. First, the parties are not called "derivatives purchasers" or "derivatives dealers" or anything that would hint at a purchaser/seller, advisor/advisee, or dealer/end-user relationship. Rather, the world is divided into "professional intermediaries" (presumably dealers) and "nonprofessional counterparties" (presumably end-users).\textsuperscript{235} Second, the DPG asserts that OTC derivatives transactions are generally conducted at arm's length. In one particular statement, the DPG asserts that taking an advisory role may mislead the purchaser in an OTC derivatives transaction.\textsuperscript{236} This would be a true statement, if the assumption of arm's-length transactions were correct.

\textsuperscript{231} See DERIVATIVES POLICY GROUP, supra note 279, at 23-25. See 1998 GAO REPORT, supra note 8, at 87-89.

\textsuperscript{232} See DERIVATIVES POLICY GROUP, supra note 279, at 26-41 (voluntarily undertaking minimum capital requirements but not assuming an advisory role with heightened duties over principals to a transaction).

\textsuperscript{233} See id. at 37-41.

\textsuperscript{234} Id. at 37.

\textsuperscript{235} See id.

\textsuperscript{236} See id. ("A professional intermediary should not make representations to a nonprofessional counterparty with a view to creating a misleading impression that the professional intermediary will assume
The Framework also appears to attempt to avoid shingle theory liability. As we have seen, transactions under the CEA do not give rise to a shingle theory. Rather than imposing a duty on futures sellers to recommend suitable investments, futures sellers are required to disclose the risks of futures trading to prospective purchasers regarding the risks of futures trading.\(^{287}\) Similarly, the Framework suggests that derivatives sellers also provide "generic risk disclosure."\(^{288}\)

Some specific provisions of the document appear to be aimed at avoiding disputes that have occurred in cases discussed in this Article. For example, in the Gibson Greetings actions Bankers Trust misrepresented the value of the contracts that the firm had arrived at through its internal valuation models.\(^{289}\) According to the Framework, "[a] professional intermediary should . . . not prepare or communicate valuations or quotations to a nonprofessional counterparty with a view to misleading the counterparty."\(^{290}\) Also, in Morgan Stanley's dispute with the State of West Virginia the State may have violated a fiduciary duty by speculating with products purchased from Morgan Stanley. Morgan Stanley became liable as a fiduciary of the investors in the fund managed by the State when it aided and abetted the State in the State's violation of the State's fiduciary duty to investors.\(^{291}\) This problem is addressed by the Framework's suggestion that "[a] professional intermediary should be aware of statutes and regulations which may apply in particular circumstances and create affirmative advisory or fiduciary duties or obligations."\(^{292}\) But these provisions are merely aspirational.

\(^{287}\) See Greenough, supra note 85, at 1007.

\(^{288}\) See DERIVATIVES POLICY GROUP, supra note 279, at 37.

\(^{289}\) See supra text accompanying notes 136-38.

\(^{290}\) See DERIVATIVES POLICY GROUP, supra note 279, at 39.

\(^{291}\) See supra text accompanying notes 205-06.

\(^{292}\) See DERIVATIVES POLICY GROUP, supra note 280, at 38.
As noted above, the DPG did not voluntarily agree to impose legal duties on itself regarding sales practices. This reluctance provides an indication that the industry will not impose shingle theory duties on itself unless forced to do so. Furthermore, self-regulation is an unlikely source for imposing duties upon derivatives dealers because of the inherent conflicts that arise in self-regulation. The NASD, the securities industry's SRO, recently demonstrated that it was incapable of carrying out the duty of regulating itself. Market makers unduly influenced the NASD regulatory process resulting in artificial spreads between "bid" and "ask" prices. The SEC discovered the practices associated with the artificial spreads and wrote a report that publicly humiliated the NASD. Although the NASD may have become tougher since the SEC's report, it has lost the appearance of an SRO because now more than half of its Board of Governors must include industry outsiders. This example suggests that there is a low likelihood that industry self-regulation will result in a remedy like the shingle theory.

233 See Allan Scott Rau, Integrity in Private Judging, 38 S. Tex. L. Rev. 485, 519 (1997) ("Entrusting complaints about professional conduct to other members of the same trade might indeed be seen as the classic case of enlisting the fox to guard the henhouse.").

234 See U.S. SEC. EXCH. COMM’N, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 46 (Aug. 8, 1996) (finding that market makers unduly influenced the NASD regulatory process) [hereinafter NASDAQ REPORT]; Richard R. Lindsey, Testimony, Director, Division Of Market Regulation, U.S. Securities And Exchange Commission of Regarding H.R. 467, The CEA Amendments of 1997 before The Subcommittee on Risk Management and Specialty Crops Committee on Agriculture, U.S. House of Representatives (April 15, 1997) (noting that the NASDAQ REPORT "describes the abuses by market makers in the Nasdaq market and acknowledges that these market makers were able to exert substantial influence over the affairs of the NASD through their role in the NASD's governance structure").

235 See generally NASDAQ REPORT, supra note 294.

236 The NASD agreed in a settlement with the SEC to keep more than half of its Board of Governors composed of industry outsiders. See NASDAQ REPORT, supra note 294, at 5.
C. Regulatory Action by the CFTC and the SEC

Although the 1998 GAO Report concluded that no further regulation of derivatives was necessary, the CFTC recently issued a concept release that suggests it is considering extending its regulation to the OTC derivatives markets. Although the release cites to the 1998 GAO Report numerous times, it did not note the GAO's opinion that there is no current need for more regulation. However, one of the CFTC's stated purposes, to "increase legal certainty," is consistent with the GAO's analysis. It is also interesting to note that the CFTC asserted that it currently has authority to regulate fraud in the swap market, but this assertion is questionable in light of Procter & Gamble.

If the CFTC's authority is extended to the OTC derivatives market, it is difficult to say whether it will apply a shingle theory. As mentioned previously, the CFTC does not normally utilize a shingle theory in its enforcement activities regarding futures markets. Because derivatives involve principal-principal rather than principal-agent relationships, the CFTC could rely on the jurisprudence of the shingle theory as it has developed in the securities context.

The SEC appears to be moving in the opposite direction. Although the SEC would appear to be a likely candidate to champion the application of the shingle theory to OTC de-

298 See generally Concept Release, supra note 275.
299 See 1998 GAO REPORT, supra note 8, at 140-41 (recommending that the President's Working Group assist market participants in reaching a conclusion as to whether arm's length relationships rather than a heightened duty should be the legal model for resolving disputes involving OTC derivatives sales practices).
300 See Concept Release, supra note 275, at 26,119. But see Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1287 & n.8 (S.D. Ohio 1996) (finding no basis for a cause of action under the CEA for a swap transaction because the swap dealer was not a CTA).
301 See Part III.D supra.
302 See Part III.A-III.C supra.
derivatives dealers, it has taken a drastically different approach toward problems with derivatives. On the one hand, the SEC has promulgated rules that indirectly regulate abusive sales practices of OTC derivatives dealers through disclosures by derivatives users. On the other hand, it has proposed rules to make it easier for OTC derivatives affiliates of broker-dealers to conduct their business.

The SEC indirectly regulates abusive sales practices of OTC derivatives dealers by requiring public companies that use OTC derivatives to disclose to their shareholders the risks that it has undertaken through the use of financial derivatives instruments. This approach is consistent with the "sunlight" as "disinfectant" underpinnings of the securities laws. By requiring companies to disclose their derivatives positions to potential investors, hopefully, corporations will be more prudent in their use of derivatives. Louis Loss explained this approach best when he said that "[p]eople who are forced to undress in public will presumably pay some attention to their figures." So how does this approach indirectly regulate sales practices? Under Exchange Act Section 21C, the SEC may issue a cease and

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305 See Disclosure Rules, supra note 303.

306 See LOUIS BRANDEIS, OTHER PEOPLE'S MONEY 92 (1914); Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. CORP. L. 1, 45-46.

desist order against "any person" causing a violation of the Exchange Act.³⁰⁸ An OTC derivatives dealer's misrepresentations of the risks involved in a transaction to a dealer would cause the end-user, if it is a public company, to violate these new disclosure rules and would bring the OTC derivatives dealer within Section 21C as well. Although this approach is not a shingle theory, it is a limited step toward regulating sales practices of OTC derivatives dealers.

The SEC is also trying to make business easier for at least some dealers. Rules proposed by the SEC would allow securities broker-dealers to register OTC derivatives affiliates with the SEC, but under less restrictive capital requirements.³⁰⁹ According to the SEC's release, it was concerned that securities broker-dealers may open up OTC derivatives affiliates in countries with less restrictive regulations than the United States.³¹⁰ Apparently, the SEC is trying to strike a delicate balance that protects investors in companies like Procter & Gamble and Gibson Greetings yet does not drive important service providers out of the country. Thus, it is unlikely that the SEC will directly impose the same shingle theory of liability on OTC derivatives dealers that it imposes on regulated securities broker-dealers.

VI. CONCLUSION

Congress could resolve much of the uncertainty that exists today if it were to enact a law applying the shingle theory to all OTC derivatives transactions whether sold by banks, futures brokers, or securities dealers. Such a law would create uniformity because it would apply the theory to the seller rather than the buyer or end-user. Currently,

³⁰⁹ See OTC Derivatives Dealers, supra note 304 (proposing rules to allow broker-dealers to register OTC derivatives affiliates with the SEC under less restrictive capital requirements than the broker-dealers themselves).
³¹⁰ See id. at 67,941.
the law, focusing more on the end-user, leaves a great deal of the regulation to the states because many end-users, such as insurance companies and state/local governments, are regulated by state laws.\(^3\) Thus, it is the fifty different state governments rather than the federal government that determine the risks that the end-users can take. The SEC’s disclosure requirement regarding risk exposure from derivatives, a federal regulation of end-users, does not apply to these state-regulated entities unless they are required to make certain filings with the SEC.\(^4\) Although it may protect people who invest in companies that file with the SEC, it does not uniformly protect people who may need money in insurance claims or people who expect that their state/local tax dollars will not be speculated away.

Although at least one commentator has questioned whether institutional investors should be afforded protection offered by shingle theory application,\(^5\) public opinion may be heading in the opposite direction. The accounts provided by Frank Partnoy make a strong case that institutional investors are no match for the derivatives-dealer "rocket scientists."

The legislators and regulators, on the other hand, have not been so quick to embrace burdening the derivatives dealers. Although numerous proposals have been presented in Congress, none have gained enough support to be enacted. In addition, OTC derivatives transactions fall through the cracks between three sets of regulators. Any move by one regulator will pose a threat to jurisdiction of the others. Indeed, when the CFTC recently issued its con-

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31 See 1997 GAO REPORT, supra note 3, at 80 (noting that state regulators are responsible for overseeing insurance company operations). See also West Virginia v. Morgan Stanley & Co., 459 S.E.2d 906 (1995) (defendant allegedly violated a state law regulating the state government’s investment activities).

317 See Disclosure Rules, supra note 303.

cept release in contemplation of more regulation, various other regulators opposed it. As such, it appears that a blanket shingle theory duty imposed by statute may be the only way to impose sufficient duties on derivatives dealers to prevent, in George Soros' words, a "meltdown." Without a crisis driving such a change, however, Congress is unlikely to enact such a statute.

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314 See Lucchetti & Schroeder, supra note 297.
315 Soros, supra note 4.